H.R. 3703—THE HOUSING FINANCE REGULATORY IMPROVEMENT ACT—PART 2

HEARINGS

BEFORE THE

SUBCOMMITTEE ON
CAPITAL MARKETS, SECURITIES AND
GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON BANKING AND FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED SIXTH CONGRESS

SECOND SESSION

JUNE 15, 21; JULY 20, 2000

Printed for the use of the Committee on Banking and Financial Services

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H.R. 3703—THE HOUSING FINANCE REGULATORY IMPROVEMENT ACT—PART 2

THURSDAY, JUNE 15, 2000

U.S. HOUSE OF REPRESENTATIVES
SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES,
AND GOVERNMENT SPONSORED ENTERPRISES
COMMITTEE ON BANKING AND FINANCIAL SERVICES
Washington, DC.

The subcommittee met at 10:08 a.m., in room 2128, Rayburn House Office Building, Hon. Richard H. Baker, [chairman of the subcommittee], presiding.

Present: Chairman Baker; Representatives Manzullo, Royce, Ryan, Sweeney, Biggert, Terry, Roukema, Riley, Kanjorski, Bensten, Waters, C. Maloney of New York, Hooley, Jones, Watt, and Capuano.

Chairman BAKER. I would like to call this hearing of the Capital Markets Subcommittee of the House Committee on Banking to order.

The Committee meets today for its third time on a series of meetings relating to the appropriate regulatory structure and market discipline of the housing Government sponsored enterprises.

To date, we have heard from the principal regulators and the GSEs themselves. It is the intention of the hearing this morning to receive comment from consumer interests as well as taxpayer watchdog organizations, as they are characterized.

I have been informed that the fourth member of our first panel this morning, Mr. Nader, is going to be detained from arriving on time, and it is my intention to proceed with the first panel and perhaps have Mr. Nader testify as an ad hoc second panel and then move on to the remainder of our witnesses later in the hearing so as to not unreasonably delay our proceedings.

I certainly want to express my appreciation to all the witnesses who are participating here this morning and certainly appreciate the effort they have exhibited in getting testimony to us in advance of their appearance here this morning.

At this time I would ask Mr. Kanjorski, the Ranking Member, if he would choose to make an opening statement at this time.

[The prepared statement of Hon. Richard H. Baker can be found on page 168 in the appendix.]

Mr. KANJORSKI. Thank you, Mr. Chairman.

Mr. Chairman, the opportunity to speak today at this third hearing on H.R. 3703, the Housing Finance Regulatory Improvement Act, is appreciated.

At our last hearings in March and May on this legislation, we heard from the present regulators of the housing Government-sponsored enterprises or GSEs, the U.S. Department of the Treasury, and the GSEs affected by this bill.

During my opening remarks at those hearings, I noted that we should move forward cautiously in considering this bill so as to ensure that we maintain the delicate balance that has led to 67 percent of U.S. families owning their own homes.

I want to reiterate that viewpoint today. As we proceed in future weeks and months, we must renew our efforts to ensure that we do not accidentally raise home ownership costs.

Although some have suggested that we should mark up H.R. 3703 later this year, from my perspective, we should not move precipitously by attempting to legislate in the 106th Congress on this complex and important set of policy issues. We should, however, continue to use H.R. 3703 as a focus of our subcommittee's oversight activities.

In order for our oversight to be effective, instructive, and objective, we must ensure that our hearings are well crafted. Comprehensive hearings will help us to methodically debate the costs and benefits of H.R. 3703. In addition, it will allow us to more thoroughly examine the many public policy issues related to the mission compliance achievement and the safety and soundness regulations of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks.

During my opening remarks at the last two hearings, I suggested that we convene a public roundtable discussion with representatives of all the interested parties. I believe that this forum is the most appropriate way for us to consider these issues. A roundtable would promote a free, fair, and vigorous deliberation by forcing the participants to challenge each other's assumptions and assertions in an open environment. It would also provide us with greater insights than would testimony that has been vetted and sterilized through the clearance process.

A roundtable would further allow us to more fully educate Members of our subcommittee about the substantive issues involved in this debate and the real effects the bill would have on our complex and successful housing finance system. I remain hopeful that as we proceed in the future with our oversight of the GSEs, our subcommittee will host a roundtable to discuss more completely the need for and the implications of this legislation.

Absent conducting such a roundtable today, we need to ensure that at each hearing our witness panels are balanced, containing a multiplicity of interest viewpoints, and a broad representation of individuals.

To improve the quality of today's proceedings, I would therefore request unanimous consent to submit for the record letters that I have recently received from a number of community advocates and affordable housing groups.

Chairman BAKER. Without objection.

[The material referred to can be found on page 170 in the appendix.]

Mr. KANJORSKI. In closing, Mr. Chairman, I look forward to hearing from each of our witnesses today. As we move forward with our

oversight, I additionally hope we will not only make a greater effort to consult one another about the structure of, witnesses for, and content of future hearings, but that we will also work together to lower home ownership costs for all Americans.

Thank you, Mr. Chairman.

[The prepared statement of Hon. Paul E. Kanjorski can be found on page 169 in the appendix.]

Chairman BAKER. Thank you, Mr. Kanjorski.

For Members on our side of the aisle, I intend to follow our established practice of recognizing Members by the time of their arrival this morning. And accordingly, Ms. Roukema would be recognized for her opening statement.

Mrs. ROUKEMA. I thank you, Mr. Chairman, and I do appreciate these hearings today.

These are very serious oversight hearings and are extremely important. I would say that Mr. Baker has raised several issues which we need to explore very carefully.

Namely, potential systemic risk due to the size of the housing GSEs, appropriate capital requirements, bank ownership of agency securities, and possible concentration problems.

At the last hearing I made it clear that I am very concerned about the allegations of mission creep. Congress created these GSEs to address a specific problem, which the private sector could not address.

They should not get into activities like real estate brokerage, mortgage insurance and consumer lending, which is beyond their specific charters. And I want to thank Mr. Baker for undertaking this very serious subject.

However, he has embarked on what will probably be an extended process—at least it is my opinion that it should be an extended process—and we should not take precipitous action.

I want to make it clear, however, that while I endorse these hearings, moving the legislation is another matter. I believe, Mr. Chairman, you will remember when you and I had the colloquy on the question of how quickly this would be moved, and I had thought that at that second hearing that we had agreed that quick action would be ill-advised, but that is evidently still an open question.

But I want to stress that all of us are for the American dream of home ownership. And based on this, we must look at and understand all the potential effects, including unintended consequences of precipitous action on H.R. 3703. None of us want to increase the cost of home ownership, even if inadvertently.

So I would say that we should look at Fannie and Freddie in all kinds of ways and support the continuation of the credit line if Fannie and Freddie meet their housing goals.

Another example of changes that should be looked at is whether or not there should be one regulator. Some would want it to be HUD, others would want the Federal Reserve to undertake the function, and I do not think it is at all clear to any of us what would be the appropriate way.

There is no consensus on this, and I think that it is a good example of why we should be very thoughtful and extended in looking at whether or not there are unintended consequences.

I just might say out of context of my statement—that it is extraordinary that we have these two groups, these groups that are before us, the left and the right meeting around the middle. That may tell us something about how carefully we should be looking at all of the consequences of this legislation.

I do think, as has already been clearly stated, that home ownership is at an all time high, and the bottom line is that the GSEs have done a great job. Without going into a lot of other details, I would like to say every year, Freddie and Fannie have exceeded the goals which HUD has set out for them, and they have adopted guidelines which prohibit the purchase of predatory loans.

I would like to put these guidelines in the record, and I think I did put them in the record at the last hearing. And I think that we should be reminded of that action today.

I also would further note that I was involved in the 1992 conference where the new capital standards for Freddie and Fannie were established.

The S&L crisis was fresh in our minds at that time, and I think we did a good job on the capital requirements for Freddie and Fannie.

They have the ten-year stress testing requirement in addition to the capital standards, which is extremely rigorous. Very few banks or savings and loans could meet the requirements which Fannie and Freddie meet, and they are in good shape financially.

That is not again to say that we should not have these oversight hearings and that some changes might be in order, but we should not be taking precipitous action, and we should be carefully evaluating this.

And I thank you, Mr. Chairman, for this opportunity in this hearing. It will again refocus our minds on American home ownership.

[The prepared statement of Hon. Marge Roukema can be found on page 209 in the appendix.]

Chairman BAKER. Thank you, Mrs. Roukema.

Mr. Capuano.

Mr. CAPUANO. No.

Chairman BAKER. No statement.

Mr. Watt, would you care to have an opening statement?

Mr. WATT. [Nods in the negative.]

Chairman BAKER. Let's see, Mr. Ryan, you would be next.

Mr. RYAN. Thank you, Mr. Chairman.

Mr. Chairman, as we found out at the last hearing, it is difficult to obtain an admission from the GSEs that they enjoy an implicit subsidy from their Government-sponsored enterprise status.

However, I firmly believe, as does the Congressional Budget Office, the GAO, the Treasury, the Federal Reserve, and Wall Street that there is an implicit subsidy.

As a result, Fannie and Freddie are able to use their GSE status to grow and profit by issuing debt at near Treasury rates while making money by taking on greater risk, such as repurchasing the mortgage-backed securities.

In a statement last September, Franklin Raines, the Chairman of Fannie Mae, said that they would achieve an annual earnings

growth of 15 percent over the next four years, which is commendable.

The problem I see with this is that in order to maintain a double-digit earnings growth as they have over the last decade, Fannie Mae will have to take on more and more risk.

Taking into consideration that Fannie and Freddie have already guaranteed practically three-quarters of the conventional and conforming mortgage market, I do not see any other way to continue the prodigious growth without breaking their congressionally mandated charters or by repurchasing greater amounts of mortgage-backed securities and thus concentrating their risk.

To this end, I am concerned about taxpayer liability as Fannie and Freddie take on greater risk to increase profitability to shareholders, something that is clearly within their realm, which is their prerogative as a private company, but not the mission as a function of public policy.

I still remain convinced that the retaining of mortgage-backed securities at this rapid pace is not the core to the GSE mission and is merely taking on more of an unnecessary interest rate risk for greater return on equity regardless of the new hedging devices that may be employed to offset the possible losses.

Further, I would like to point out that an important statement from Chairman Greenspan in his May 19th letter to you, Mr. Chairman, is noteworthy. It is a point that is often taken for granted in this debate.

But Greenspan writes, quote: "The Federal Government guarantees, implicit or explicit, are one way, along with Government outlays and mandates in the private sector, that the Federal Government makes claims on the real resources of the private sector. Subsidies accorded to GSEs are of necessity at the expense of other Federal or private-sector initiatives and hence are ultimately financed by households either through taxes or through reduced accumulation of wealth."

We often hear about the outright benefits that the GSEs get that accrue to Americans to lower mortgage rates, but in many ways we rarely discuss the hidden costs. And that is why I am pleased that we are having these hearings and we are going into these issues.

I am also concerned that Fannie and Freddie may seek to expand into areas outside of the conventional conforming housing market, things we just heard from Ms. Roukema.

Aside from moving into Jumble loans and sub-prime loans, Fannie and Freddie could use their special status and cheap bonds to move into general financial services such as home equity loans or other consumer credit markets.

Unfortunately, this implicit Government subsidy would give them an unfair advantage over their would-be competitors.

I believe that Fannie and Freddie have played a very important role. They are playing a very important role in securitizing the secondary market, and I do not think anybody here is really rejecting that.

The point is, this relationship is an odd one. It is an odd relationship where there are two mandates or two bosses, so to speak.

There is a shareholder mandate, and there is a Government mission mandate. And in many ways, those two mandates are contradictory toward one another.

That is why I think it is important that we in this Committee reveal and look into these conflicting mandates to see if we are moving beyond the best interests of the taxpayer or whether we are still within those confines.

And that is why I am pleased that we are having these hearings, and I look forward to hearing the witness testimony later on today.

Chairman BAKER. Thank you, Mr. Ryan.

I am advised that we have one vote pending now on the House floor. I would suggest that we recess our proceedings and reconvene as quickly as possible.

Thank you. We will be back momentarily.

[Recess.]

Chairman BAKER. If I could ask everyone to take their seats, we will reconvene our hearing this morning.

The last Member to give an opening statement was Mr. Ryan, so at this time I turn to the Democrat side, Ms. Hooley.

Ms. HOOLEY. Thank you. I have probably more questions than an opening statement today. This is an issue I think we need to all understand how it affects our consumers, and I am looking forward to the hearing today.

Thank you.

Chairman BAKER. Thank you very much.

I do not know if we have other Members to return quickly or not. What I would suggest we do in order to facilitate our hearing is just to proceed. If other Members choose to enter their opening statement into the record, certainly that will be done without objection.

I am pleased to see that Mr. Nader has been able to join us. I thank you for your courtesy in getting here as close as you could to schedule this morning. As I said earlier, we have a very distinguished panel of witnesses representing various consumer perspectives this morning, and I do not know that Mr. Nader needs a particularly lengthy introduction.

I would be shocked if anyone in the room does not know the credentials and history of Mr. Nader's profuse activities on behalf of consumers on a number of issues, and I am particularly pleased that, Mr. Nader, you had time to join the subcommittee this morning and give us your perspectives on Government-sponsored enterprises and any remarks you might choose to make about the pending legislation, H.R. 3703. Welcome to the Committee, Mr. Nader.

STATEMENT OF RALPH NADER, CONSUMER ADVOCATE, WASHINGTON, DC.

Mr. NADER. Thank you very much, Chairman Baker and Members of the Subcommittee:

I am quite pleased that you are holding this hearing, especially to receive comment on your legislative effort to upgrade the oversight regulation of the three Government-sponsored enterprises which dominate the housing finance markets.

While there are clear differences between the thrift industry and GSEs, H.R. 3703 is a reminder of what Congress failed to do to protect the taxpayers and the savings and loans a quarter of a century ago.

For years, this Committee and its companion Banking Committee in the Senate handled the savings and loan industry with soft kid gloves.

The Federal Home Loan Bank Board was allowed to carry out its functions more as a cheerleader than a regulator of financial institutions.

And so when the savings and loan industry began to fall apart in the 1980's, it was politically difficult to impose stringent regulations and higher capital standards on this industry.

Only after the failures caused staggering multi-billion dollar losses to deposit insurance funds and taxpayer funds did the Congress reform the regulatory machinery, raise examination standards, and establish mandatory criteria to trigger an early warning system and require prompt corrective action.

Looking back at this episode, Mr. Chairman, historians will wonder how the Congress could have failed to establish these protections long before the disasters of the 1980's.

And of course, others honestly viewed the savings and loans as a primary source of funds critical to the production of badly needed housing in their districts, while other Members of Congress were very chummy with the industry and too willing to look the other way when the speculators and quick buck artists moved into the industry.

As a result, tough oversight and strong regulation was not imposed on this industry. Of course, the savings and loans people were quite happy to use this line as a defense against what few reformers ventured forth in the Congress.

In the end, this "see-no-evil/hear-no-evil/speak-no-evil" approach to oversight and regulation left the thrift industry a near wasteland and the taxpayers an estimated half a trillion dollars poorer in principle and interest over a thirty-year period.

Today, the housing GSEs and their supporters are borrowing pages from the old savings and loan manuals on how to slow reforms.

Any suggestion for change in the high flying lifestyle of Fannie Mae, Freddie Mac or the Federal Home Loan Banks invariably elicits an immediate bombardment of charges from the GSEs that proponents of reform are destroying the great American dream of home ownership.

Quote: "It is a tax on home ownership," is a favorite cliché of Fannie Mae in response to even the mildest proposal for reform.

I once said to a Fannie Mae executive: "I guess your higher and higher salaries are also a tax on home ownership." Congress needs to look behind such facile, anemic defenses.

For too long, Congress has played the role of an indulgent parent to the GSEs, with few exceptions, such as yourself.

The GSEs have long since grown beyond adolescence. It is time for the GSEs to give up ties to the Federal Government that have made them poster children for corporate welfare.

Most of all, Congress needs to look more to the protection of taxpayers and less to the hyperbole of the GSE lobbyists that form a standing army on Capitol Hill, some of whom are right in this room.

The housing-finance GSEs were born as creatures of the Federal Government and have evolved as hybrid enterprises where much of the risk remains with the Government and the taxpayers while the profits flow to private shareholders.

Chairman Baker, your bill, H.R. 3703, takes a big step toward providing a more rational and stronger regulatory system and removing some of the more obvious subsidies to the GSEs.

H.R. 3703 creates a five-member, full-time, presidentially-appointed Housing Finance Oversight Board as an independent agency and consolidates all regulatory authority for the GSEs under that Board.

This will eliminate three separate agencies.

One, the Office of Federal Housing Oversight, known as OFHEO; the Federal Housing Finance Board; and the Secretary of Housing and Urban Development, which currently share supervision of the housing GSEs.

The establishment of a single regulator for the housing GSEs tracks the 1997 recommendations of the General Accounting Office—whose budget needs to be restored, by the way, to its former self. It will provide greater focus and consistency on oversight and safety and soundness of the housing GSEs than is possible in the present scattered system. The Board will include the Secretary of the Treasury, Secretary of HUD, and three citizen members.

When this Committee was considering the so-called financial modernization legislation during the last three Congresses, I urged the same type of consolidation of the separate agencies that regulate depository institutions. That proposal got nowhere. I hope the future of supervision of the GSEs fares better.

There is one modification, however, I would urge for the single-agency approach to the housing GSEs. I strongly recommend that the Department of Housing and Urban Development continue to analyze and establish housing goals and transmit them to the independent board established under this legislation for enforcement.

At a recent conference, a high official in HUD made the following statement, and I will paraphrase it. He said, "Yes"—this was William Apgar, Assistant Secretary of Housing and Urban Development. Here is what he said:

Quote: "There are two clear and indisputable facts. One, the number of Americans in need of affordable housing stands at an all-time high. Two, Fannie and Freddie are making record profits."

I could add, three, Fannie and Freddie executives are making record compensation pay packages.

HUD remains the Federal Government's expert on housing needs and this expertise should be utilized beyond the provision that the HUD Secretary be a member of the new board.

Just as important, the legislation clearly focuses the board's attention on safety and soundness, and this focus needs to be maintained while HUD continues to provide the expertise on housing goals.

The legislation should also include provisions that will require ongoing disclosure of data by the housing GSEs that will provide specific information to enable the board and the public to track the geographical location, race, gender, and income levels of the homeowners whose mortgages are purchased by the GSEs. This should be disclosed by census tract.

In addition, the board should be subject explicitly to the Freedom of Information Act and Sunshine Act requiring open meetings. That really needs to be made explicit.

In an obvious effort to overcome the money problems that have hampered the operations of OFHEO, the bill provides for the board to be financed through assessments on the GSEs for, quote: "reasonable costs and expenses", without being subject to the appropriations process. I have misgivings about any Federal agency escaping the appropriations process—to wit, the Federal Reserve Board—but I recognize that OFHEO has special problems with the current process, problems that affect its ability to carry out its responsibilities.

OFHEO, as the safety and soundness regulator of Fannie Mae and Freddie Mac, is forced to continually battle to hang onto its meager budget. Earlier this month, an appropriations subcommittee whacked nearly $5 million off of OFHEO's request for $26.7 million. This means fewer examiners and financial experts to track Fannie and Freddie's far-flung empires.

In pleading for his budget, Armando Falcon, the Director of OFHEO, pointed out that his agency is trying to examine enterprises that own or guarantee $2 trillion of residential mortgages.

To cut the budget of an agency trying to cope with these mammoth financial institutions is an outrage; a slap at the taxpayers who unfortunately bear the ultimate risk. Where are the investigative reporters who should be trying to find out what is going on in the House Appropriations Committee? There they are. They are over there at the table.

[Laughter.]

Is this the result of more of the ham-handed lobbying by Fannie and Freddie to limit scrutiny of their operations?

OFHEO's budget problems are a prime example of why the reforms in the Baker bill are badly needed now. Not only do the GSEs dominate the mortgage markets, but they have a huge share of the U.S. debt market.

As Chairman Baker has pointed out in these very hearings, the GSE debt of $1.4 trillion combined with GSE-guaranteed mortgage-backed securities of $1.2 trillion nearly total the $2.7 trillion of outstanding privately-held marketable Treasury debt. The Treasury Department estimates that the GSE debt may double to $3 trillion by 2005 and surpass the Treasury debt in three years.

We are obviously not talking about GSEs interested only in providing the American dream of home ownership, as their national advertising campaigns suggests. They have a big appetite that grows bigger as they saturate the mortgage market. They will reach out more to maintain their high levels of profits and shareholder dividends.

H.R. 3703 wisely gives the Oversight Board the duty of reviewing and limiting activities that go outside the GSEs mandate.

A lot of Fannie and Freddie's profits come from their links with the Federal Government, which they retained after becoming a "private" shareholder corporation. These ties to the Government have given the GSEs great benefits in the marketplace, and as a result of these benefits, the GSEs are able to borrow in the market at interest rates very close to that enjoyed by the Federal Government itself.

A study by the Congressional Budget Office estimated that 40 percent of the earnings of Fannie and Freddie in some years could be traced to the benefits of their Government-sponsored status.

Mr. Raines disputes that. He may be asked about his basis for that. Even Alan Greenspan, Chairman of the Federal Reserve Board, has chimed in with criticisms of the subsidies that pad the GSEs bottom line.

The GSEs defend this largesse with the claim that the subsidy is passed on to home buyers. CBO's studies debunk the claim. It says that a third of the subsidy at least is pocketed by private shareholders, the corporations' executives, and lobbyists.

Now, H.R. 3703 eliminates one of the most egregious forms of corporate welfare—a standby line of credit that could be drawn from the Treasury if the GSEs fell on bad times. Fannie and Freddie each have a $2.25 billion contingency fund at Treasury, and the Federal Home Loan Banks a $4 billion line of credit.

Other benefits remain, including the exemption from local and State income taxes. Even when the District of Columbia was struggling on the edge of bankruptcy, Fannie Mae refused to cough up a dollar in lieu of the $300 million in taxes they escape annually through the exemption from District income taxes.

And of course, they always imply that if they are ever required to pay District income taxes, they will move out to another jurisdiction that will be more permissive in inviting this tax escapee from the District of Columbia.

In addition, the securities of Fannie and Freddie are Government securities for the purposes of the SEC Act of 1934 and are exempt from registration. Their securities serve as eligible collateral for Federal Reserve Bank discount loans, and the Federal Reserve serves as fiscal agent for these issues. In addition, the Secretary of the Treasury approves the issues.

The obligations are also eligible for unlimited investments by national banks and State bank members of the Federal Reserve as well as federally-insured thrifts.

All these links are evidence in the eyes of the market that the Federal Government would rush to bail out the GSEs if they were in serious financial trouble. The market looks on these entities as fail-safe organizations.

Chairman Baker has expressed concern about the fact that GSE debt has become a significant part of the assets of the banking system—an estimated $210 billion at mid-year 1999. National banks may invest no more than 10 percent of their capital in corporate bonds of one issuer. But, because of the special GSE provision that I noted earlier, bank investments in GSE debt securities are not limited.

H.R. 3703 calls for a study by the FDIC of the impact that a GSE failure would have on the solvency of the banks. It is important that this study goes forward.

Clearly, the special status of the GSEs has provided lucrative benefits for its executives. *The National Mortgage News* in an article headlined "Who Wants to be a GSE Millionaire?" recently came up with the figures on the top executives for 1999 and they are in the prepared testimony.

I will just point out, however, in a bizarre display of self-restraint, which I commend, the Chairman of Freddie Mac, Leland Brendsel, is making only $1,405,000, which is less than Fannie Mae's Vice Chair, Jamie Gorelick, recently of the Clinton Administration. She is making $1,443,978. I hope that if Mr. Brendsel hears these remarks he will not ask for a raise.

While the executives may be doing well, there are important questions about the adequacy of GSEs' support for housing in low- and moderate-income and minority neighborhoods.

An analysis of 1998 data conducted by Jonathan Brown of Essential Information indicates that in many MSAs, the GSE market share of 1 to 4 family mortgage loans in low- and moderate-income and minority neighborhoods was only one-half the GSE market share of such loans in upscale, non-minority neighborhoods.

Now Mr. Brown has very, very detailed information on this and specific maps covering most of the United States, and I would urge Members of the Committee and the Committee's staff to contact Mr. Brown for further information.

Another study conducted by the National Community Reinvestment Coalition says that Fannie and Freddie lag behind banks in financing single-family mortgages for minorities and low- and moderate-income home buyers.

That study, based on 1995 and 1996 data, found that only 32 percent of Freddie's and 33 percent of Fannie's loan purchases involved single-family mortgages for low- and moderate-income home buyers. In contrast, the study said 41 percent of banks' single-family loans went to such borrowers.

The emphasis in H.R. 3703 is on safety and soundness, and that is important. But this Committee also needs to do more to examine the adequacy of the housing goals and the performance of the GSEs on affordable housing in low- and moderate-income minority neighborhoods, and that is Jonathan Brown's specialty.

The regulatory improvements mandated by H.R. 3703 should be adopted by the Congress in this session. They are long overdue, and there is no reason to delay these taxpayer protections any longer.

As this Committee proved in the enactment of reforms in the wake of the savings and loan debacle, bipartisan coalitions can be formed successfully on safety and soundness issues in the oversight of Federal regulation. This should happen now while the GSEs are prosperous, not when the fortunes of these institutions are sagging.

Some Members may feel these institutions are so strong and so wealthy there is no need for the protections incorporated in H.R. 3703. They see no possibilities of downturns in their fortunes. But this ignores history.

Few foresaw the collapse of the savings and loan industry. Even fewer believed tax money would be used to bail out insured institutions. But it happened, and the regulators, and for that matter the whole Nation, were poorly prepared for the disaster.

Fannie Mae has had its own downsides. In the early 1980's, for example, Fannie was technically insolvent on a market-to-market basis and was losing money at the rate of $1 million a day.

Congress should act on this legislation while the sun is shining.

Thank you.

[The prepared statement of Ralph Nader can be found on page 220 in the appendix.]

Chairman BAKER. Thank you very much, Mr. Nader. I really do appreciate your willingness to be here today and your forthright testimony. Thank you very much.

Mr. NADER. Thank you.

Chaiman BAKER. Our next witness is Mr. John Taylor, who is President and Chief Executive Officer of the National Community Reinvestment Coalition.

I would like to point out for the record that previously you have served on the Consumer Advisory Council of the Federal Reserve Board. You have been on Fannie Mae's Housing Impact Advisory Council, and also on Freddie Mac's Affordable Housing Council. And I think it important for Members to know of your prior relationships with these organizations.

Welcome, Mr. Taylor.

STATEMENT OF JOHN E. TAYLOR, PRESIDENT AND CEO, NATIONAL COMMUNITY REINVESTMENT COALITION

Mr. TAYLOR. Thank you, Chairman Baker. Thank you for asking the National Community Reinvestment Coalition to testify this morning on the question of consolidating oversight of the Government-sponsored enterprises.

I do want to say that the mission of the National Community Reinvestment Coalition is to increase access to credit and capital for underserved neighborhoods, including inner city and rural communities.

Toward that end, access to home ownership is an incredibly important part of our mission. And so I would like to associate myself with the remarks of Mr. Kanjorski and Mrs. Roukema on being leery and careful about any unintended consequences from any precipitous action.

Nonetheless, we do support the effort to consolidate oversight of the GSEs by replacing the three regulatory agencies with one.

A report by the GAO correctly suggests that a single regulator will enhance the compliance of the GSEs with their mission of providing financing of affordable housing in a safe and sound manner.

A single regulator will be more efficient, we believe. One agency will find it much easier to coordinate regulation over safety and soundness and regulation over the mission of financing affordable housing. A single regulatory agency will also be more prominent and influential, in our opinion.

A regulatory agency must be strong enough politically in order to enforce robust standards in affordable housing finance. HUD has done a commendable job implementing affordable housing goals for

Fannie Mae and Freddie Mac, particularly I might say under Secretary Cuomo's leadership. But more needs to be done.

The two GSEs have significantly increased their purchases of mortgages made to minority and low- and moderate-income populations.

In a report published for HUD, however, we found that Fannie and Freddie trail the banks, as Mr. Nader mentioned in his testimony, in the percentage of mortgages financed that were issued to minorities and low- and moderate-income populations.

We also mentioned that while NCRC believes that our research was careful and our conclusions sound, we agree with Fannie and Freddie that the data on secondary market activity needs to be improved.

Again, this is where a strong regulatory agency can ensure that complete and accurate data are gathered so as to better measure GSE compliance with their missions.

The Federal Housing Finance Board is in the middle of a rulemaking exercise that will make permanent the pilot secondary market programs of the Federal Home Loan Banks.

The FHFB, however, did not propose any affordable housing goals. NCRC disagreed with this. We believe that the regulatory agencies must implement such goals for any new secondary market program. This would ensure that all GSEs do their part in financing affordable mortgages.

A word now on safety and soundness as it relates to predatory lending.

A strong regulatory agency takes bold steps to curb predatory lending practices that harm consumers and also threaten the safety and soundness of the GSEs.

The leadership of Fannie and Freddie realized that they must not finance unsound predatory practices. And to their credit, Freddie Mac's CEO Leland Brendsel and Fannie Mae's CEO Franklin Raines have announced that they will not purchase loans with prepaid credit insurance.

They have stated that they will not finance loans featuring usurious interest rates and steep fees.

These are important steps, Mr. Chairman, but it is also important to recognize that Mr. Brendsel and Mr. Raines will not have control of the reins at Freddie Mac and Fannie Mae forever.

Also, and probably more importantly, there are many other predatory mechanisms in addition to credit insurance and high fees that strip wealth that are not addressed in the GSEs' commitment to not be involved in predatory lending practices.

To ensure comprehensive protection against predatory lending, the Federal Reserve should use its regulatory authority under HOEPA to lower the interest rate and fee thresholds for high cost loans.

The Federal Reserve should also limit and prohibit abusive practices such as high balloon payments, steep prepayment penalties, and lending without regard to the borrower's ability to repay.

H.R. 3703 should empower a new regulatory agency that will prohibit the purchase of predatory loans with abusive terms and conditions.

Predatory lending threatens the progress that has been made in reinvesting in minority and working class neighborhoods.

Part of a comprehensive solution to eliminating predatory lending is aggressive oversight and regulation of GSE involvement in the subprime market.

A word if I could on data disclosure, Mr. Chairman. Section 103 of H.R. 3703 requires that the GSEs publicly disclose financial and other information that is in the public interest.

We commend you, Mr. Chairman, for including this provision in the bill. Publicly accessible data is the key to holding the GSEs accountable for efficient and equitable financing of mortgages.

NCRC also asks the Chairman to consider enhancements to HMDA data and other databases on GSE activity that would provide more information on loan terms and conditions.

Recently in their request for public comment, the Federal Housing Finance Board asked if a database on Home Loan Bank secondary market activity should include information on prepayment penalties, FICO scores and other characteristics of mortgages and borrowers.

NCRC strongly supported the inclusion of this information in the Federal Housing Finance Board database and urged that this data be public.

NCRC supports this type of information being publicly available in HMDA and the public use database as well. All of the databases should also have information on the annual percentage rate.

Mr. Chairman, consumers, regulatory agencies, and financial institutions have a right and a responsibility to understand how credit scoring systems judge the ability of consumers to pay their loans.

Greater transparency of the credit-scoring system would enhance the safety and soundness of the financial industry by allowing all parties to question and debate the soundness of the credit-scoring criteria.

Greater transparency also helps additional minority and low- and moderate-income borrowers prepare themselves for home ownership.

NCRC believes that the borrower has a right to know his or her specific credit scores and the factors that went into that score.

Fair Isaac and Company has just announced that it will start providing borrowers their credit scores. Likewise, the GSEs should disclose the credit scores and the factors behind those scores for any scoring system they develop.

H.R. 3703 should require disclosure of any GSE credit scores. The regulatory oversight agency must also continue conducting fair lending testing of the GSE underwriting systems as HUD has just started to do.

Some brief comments about the structural and jurisdictional issues:

As stated above, NCRC agrees with the GAO that a single regulatory agency would be more efficient. We are not convinced, however, that the regulatory agency needs to have a board representing many different interests.

HUD is a logical choice, because it carries the prominence of a cabinet-level department and has been the regulator for both safety

and soundness and mission compliance for Fannie Mae and Freddie Mac.

Perhaps a new oversight agency within HUD can be on a semi-independent basis like OFHEO is now. To bolster its position of independence and prominence, the new agency should be funded by assessments on the GSEs instead of through the appropriations process.

H.R. 3703 wisely adopts such assessments as the funding mechanism.

H.R. 3703 has generated some controversy regarding Section 110, which grants the new regulatory agencies the authority to approve new actions undertaken by the GSEs. NCRC agrees that prior approval authority and public comment periods are necessary.

Currently, HUD has approval authority over new programs of Fannie Mae and Freddie Mac. The regulatory agency must have prior approval authority in cases in which they think the products go beyond the GSE charters.

In the event that Fannie Mae and Freddie Mac and the Home Loan Banks do not meet the affordable housing goals, the oversight body should be in the position to prohibit new products that do not have the capacity to serve substantial numbers of minority and low-income borrowers or consumers.

NCRC believes that the GSEs should continue to have access to the lines of credit with the Department of the Treasury if the GSEs continue to meet their affordable housing goals. NCRC proposes that the line of credit be cut off if a GSE does not meet its affordable housing goals for two consecutive years.

I request that my written remarks be entered into the record, and I thank you for the opportunity to testify.

[The prepared statement of John E. Taylor can be found on page 238 in the appendix.]

Chairman BAKER. Thank you very much, Mr. Taylor. Without objection, all witnesses' written statements will be included in the record. Thank you.

Our next participant is Mr. Peter Skillern, who I point out for the record is a member of HUD's Treasury Task Force on Predatory Lending and also a member of the HUD Government Sponsored Enterprise Oversight Committee, but appears here today in his capacity as the Executive Director of the Community Reinvestment Association of North Carolina, where he has been engaged for fifteen years in community redevelopment activities.

Welcome.

STATEMENT OF PETER SKILLERN, EXECUTIVE DIRECTOR, COMMUNITY REINVESTMENT ASSOCIATION OF NORTH CAROLINA

Mr. SKILLERN. Thank you, Mr. Chairman.

CRA-NC's mission is to promote and protect community wealth, and we have done that by promoting investments into low-income communities. We have tried to protect them by being at the forefront of the anti-predatory lending initiative in North Carolina.

My comments today address directly three questions that your bill raises.

Is there a need for regulatory reform regarding the GSEs? And I would say, yes, there is, to the extent that we need to improve their performance. The structure of that seems to be less important to me as the political will to be able to actually implement what the guidance levels are.

Product review. I think that HUD already has some of the important tools to be able to implement the review process. The question is whether it will be actually implemented to guard against those products which are harmful rather than helpful to promote home ownership.

And is there a need for Government-sponsored enterprises in their role in the secondary market where they do receive Government benefits?

I would say, yes, there is. Conditional on the fact that they fulfill those missions and exceed the market in promoting affordable home ownership for our constituencies.

These hearings play a really important role in highlighting the GSEs charter and their mission. It highlights the fact that this charter is not a right, it is a privilege and must be continually earned.

I would like to recognize that Fannie Mae and Freddie Mac have done many good things for affordable housing communities, and Fannie Mae in particular can be noted for its partnership offices and its foundations contributions. And I hope that that hopes to ease some of the criticisms that may come following this.

One, communities. Fannie Mae and Freddie Mac need to improve their lending to minority communities.

In my testimony I highlight the discrepancies between the minority purchase loans, between Fannie and Freddie, and the standard market.

I have also included a highlight of an article from the *News and Observer* which shows the level of participation in my hometown of Raleigh-Durham.

The GSEs have questioned these numbers. They have done many good initiatives, but fortunately they have agreed that, yes, more can be done.

The effect of not having a strong, active presence of GSEs in these minority communities is that banks will not make loans where they cannot sell them to the secondary market. They cannot take on the risks and the expense, and so loans are not made.

When loans are not made, it creates a credit gap, and the credit gap is where subprime lenders step into the market to fill.

According to HUD's April 2000 report, "Unequal Burden: Income and Racial Disparities in Subprime Lending in America", subprime loans are five times more concentrated in black neighborhoods than in white neighborhoods.

We would say that there is a correlation between the banking activities of providing prime market and the GSEs support of those activities and then the rise of subprime lending, and it would end that credit gap that is created.

Subprime lending can be a very powerful and beneficial tool to credit building for people with impaired credit. It can be a great tool for democratizing credit to allow more people access to it. But

there are some severe problems in the marketplace that we are concerned about.

One is a pricing problem.

How much should people be charged with impaired credit? According to a report by Freddie Mac, 10 to 35 percent of borrowers who obtain mortgages in the subprime market were actually eligible for conventional loans.

And according to Fannie Mae, half of all subprime borrowers could have qualified for lower cost conventional loans.

Clearly, the subprime market is not simply serving those with impaired credit, but a significant portion who should have been getting credit from prime lenders in the banking market.

Two, there are different and unfavorable terms and conditions within the subprime market.

While subprime lending is predatory through outright deception and fraud, and it is easy to point to and say this is wrong and illegal, there is a wide range of practices that cumulatively, as they act together, serve to strip wealth and income from lower income individuals.

While no individual one consumer lending practice may be bad, as a whole they end up having the effect of being wealth depleting, not wealth creating.

Our third major concern with the subprime market is that it is unregulated.

Depository mortgage institutions are regulated by the FDIC, the Federal Reserve, the Office of Thrift Supervision, and the Office of the Comptroller. The same cannot be said of mortgage brokers and nondepository mortgage lenders and warehouse lenders.

They are regulated only on a complaint-driven basis by HUD and the Federal Trade Commission. They are not evaluated on a regular basis for compliance.

These three things—pricing, different terms and conditions, and not being regulated—create a market which the GSEs have both indicated that they are entering into. To date, Fannie Mae has not significantly and Freddie Mac has.

Freddie Mac at the end of 1999 had purchased approximately $8 billion worth of wraps—guarantees on the mortgage securities for subprime lenders—and according to *Inside B and C Lending*, plan to do another $8 billion worth of wraps in the coming year. That is an increase of almost 50 percent of their last year's activities.

Is this good or is this bad?

Well, let me give you an example of a loan from one of their partners, Option One.

Mary and Tom Smith needed to consolidate some debt, and they got their loan from Option One, one of Freddie Mac's prime partners. The Smiths are retired. They borrowed recently to help one child through college and one child with a bout of cancer. Their payment history is good, and they are African American.

Armada Mortgage of Raleigh told the Smiths they could reduce their monthly payments by consolidating their debt. The interest rate would be 8 percent. This was a year ago. At closing, they found that the interest rate was actually 9.75 to 10.75 percent APR.

The monthly payments would not be $1,450 as promised, but over $1,700. The Smiths were charged $7,400 to originate the loan of $172,000—$7,400; that is over 4 percent. Their existing mortgage of approximately $123,000 was refinanced from a lower interest rate to a higher interest rate.

Now at closing, the Smiths realized that some of these loan terms were different. In fact, there was also a balloon payment of $150,000 on a total $182,000 loan due in fifteen years.

They said, "This is not what we wanted," and the broker assured them that they could refinance in two months. Being too polite to walk out of the deal, which is a common experience in my interviews of people with subprime loans, too polite to walk out and say "no," they signed.

When they were not able to refinance with that same broker and that promise did not come through, they went to another lender to refinance and found that, in fact, they had an $8,500 prepayment penalty locking them into those onerous terms and conditions.

The prepayment penalty by itself may not be bad, but it became the glue for these higher interest rates loans.

This loan demonstrates our concerns about the GSEs entering into the subprime market. The Smiths have good credit history, but were charged a high interest rate and abusive fees on their subprime loans.

It is industry practice to pay a yield spread premium to place borrowers in higher rate loans so that everyone downstream gets to make more money off of that loan, and the prepayment penalty locks them into it.

While Fannie Mae and Freddie Mac have both agreed to limited—Fannie Mae has adopted more of our principles that we are recommending, Freddie Mac has adopted fewer, and there are not adequate self-guiding guidelines for them to prevent buying these types of loans, in fact Armada Mortgage sold it to Option One and Option One then partners with Freddie Mac to wrap the loans.

Here is the real kicker for us.

We are concerned that this is a fair housing issue. If on one hand you are not making adequate loans, below market loans to minorities on this hand, but on this hand are purchasing or wrapping subprime loans with higher interest rates and higher fees in a disproportional representation to minority markets, there is a fairness issue here.

This hand should be higher than what the market is providing prime product. This hand may not need to be here. If we are going to do subprime markets, terms and conditions cannot have such a disparate difference between the two.

And in our testimony you will see graphs representing the proportional purchasing of Option One versus Freddie Mac.

Safety and soundness:

The Smiths will have a hard time making this loan. If they default, will that hurt Freddie Mac and the wraps? No. Given their current level of size, the danger of subprime lending is not a current threat. But with the increased purchases of subprime lending, we are very concerned that it becomes a safety and soundness issue. But we are primarily concerned about that family and that neighborhood, and neighborhoods across America who will have

higher default delinquency rates because of these high-cost lending loans.

Solutions:

One, I would argue that corporate responsibility is an important one. One is for the GSEs to adopt the guidelines that we have provided in the back.

Another recommendation is to commit more financial and human resources to the task of community lending to increase this side of the equation.

Again, I want to recognize the good efforts that both institutions have done, particularly Fannie Mae. Freddie Mac is beginning to invest more with the establishment of a new community development lending office in North Carolina, but we certainly look forward to more.

And for Freddie Mac, there is a list of recommendations in the testimony for what can be done.

Regulatory reform.

We think HUD already has the authority to define the entry into the subprime lending as a new program and to exercise its oversight to draw the boundaries of what should and should not be allowed.

Specifically, the new affordable housing goals, the GSEs should not be allowed to receive credit for affordable housing goals that are not monitored for compliance with fair housing, that have prepayment penalties, origination fees over 3 percent, or single-premium credit life insurance.

HUD does need to be given authority to have an on-site presence at the GSEs to monitor, and they need the adequate resources to do the job. And so we are very supportive of the idea of an assessment fee on the institutions to pay for both OFHEO and HUD's costs.

Additionally, we think OFHEO should be given the authority to evaluate for consumer compliance issues, not only safety and soundness, as this stream of loans that they are now entering into, as I have demonstrated, are not regulated. And OFHEO needs to be looking at that issue as well.

A new regulatory framework may, as you recommend, may have been needed. But I think more important than that is for all of us today to exercise our moral and legal authority to make sure that this equation of fairness of more loans for minority and low-income communities, and healthy, safe loans in the subprime market, are the call of the day.

Thank you very much.

[The prepared statement of Peter Skillern can be found on page 247 in the appendix.]

Chairman BAKER. Thank you very much, Mr. Skillern. We appreciate your testimony.

Our final witness on this panel is Mr. William Cunningham, whom we welcome this morning. Although testifying today as an independent investment analyst, in your professional life you are employed by the Board of Pensions of the Evangelical Lutheran Church, and we certainly welcome your presence here today.

STATEMENT OF WILLIAM M. CUNNINGHAM, BOARD OF PENSIONS, EVANGELICAL LUTHERAN CHURCH IN AMERICA

Mr. CUNNINGHAM. Thank you, Mr. Chairman. Thank you, Representative Kanjorski, Members of the Subcommittee also for giving me this opportunity to testify on the supervision and regulation of Government-sponsored enterprises or GSEs.

Your bill, H.R. 3703, the Housing Finance Regulatory Improvement Act, comes at a critical time. The bill proposes a new regulatory structure for the three Government-sponsored enterprises.

Given the importance of the legislation, I am honored to have this opportunity to comment. It is appropriate to note, as you did, Mr. Chairman, however, that my comments represent my own views and are not meant to represent the views of my employer, the Board of Pensions of the Evangelical Lutheran Church in America. Nor do my views represent the opinions of the GSEs or Wall Street. I come before this subcommittee as an independent analyst.

I would also like to take a minute and point out or mention one person I brought with me, my mother, Marie Cunningham Brown, who worked on Capitol Hill for twenty years as a staff member and put together many of these types of hearings. Her last posting on the Hill was with the great and good Representative Claude Pepper. So if I know anything about testifying on Capitol Hill, it is because I watched her put together many of these hearings.

Now let me move on to my remarks. I will divide my remarks into five parts.

First, a general discussion of social investing.

Second, a description of the GSEs role in social investing.

Third, background information on my activities in both social investing and the secondary mortgage markets.

And fourth, I will outline my concerns with the GSE performance in fulfilling their public purpose mission.

I will end with my views on certain aspects of the Baker bill.

So if we could, let us take a look at social investing really quickly. Social investing describes a style of investing combining a desire to maximize financial return with an attempt to maximize social good.

Many believe social investing began with the Religious Society of Friends, better known as the Quakers. In 1758, the Quaker Philadelphia Yearly Meeting prohibited members from participating in the business of buying and selling humans. Religious institutions have been at the forefront of social investing ever since. And in the interest of full disclosure, I will note that I am a Quaker.

In general, social investors favor environmentally responsible corporate practices, corporate practices that support workforce diversity, and corporate practices that result in increased product safety and quality.

Social investing preferences are broad, however. Certain social investors prefer not to invest in companies involved in the production of medical equipment used in performing abortions, for example.

Now the field has actually grown quite steadily over the course of the last decade. According to a study released by the Social Investment Forum, a nonprofit professional association dedicated to

promoting socially responsible investing, more than $2 trillion is now invested in a socially responsible manner in the U.S.

Now I am going to talk real quickly about social investing strategies and tie that to the GSEs. Social investors tend to use three basic strategies.

The first is screening, and we are all familiar with screening investments. That is basically eliminating certain securities from a portfolio based on social criteria. Many social investors actively screen out tobacco company investments, for example.

The second strategy that social investors use is shareholder activism. Shareholder activism efforts attempt to positively influence corporate behavior. They basically include things like initiating conversations with corporate managers, dialoguing on issues of concern, and submitting and voting proxy resolutions.

The final social investing strategy is positive investing. And positive investing involves making investments in activities and companies believed to have high and positive social impact. Positive investing activities tend to target underserved communities. These efforts support activities designed to provide mortgage and small business credit to minority and low-income communities. It is in this area that Freddie and Fannie are most active.

Now if we look at social investing in the secondary mortgage markets, I am going to talk a little bit about activities that I have undertaken in this area, starting back in 1992, and tie that in again with the GSEs.

Going back to a 1996 article in *The Washington Post*, I commented that, quote: “It seems Freddie and Fannie’s primary mission has been completed and completed successfully. Now it is time to look for a different mission, which could include finding mortgage money for low-income parts of the District and housing the homeless.”

Others have recently echoed this sentiment. Federal Reserve Board Chairman Alan Greenspan noted in a letter to you, Mr. Chairman, dated May 19th, 2000, quote: “The GSEs were chartered with the purpose of smoothing out regional imbalances in mortgage supply and integrating regional mortgage markets into the National capital markets. Much to their credit, they succeeded in accomplishing this goal many years ago.”

Mr. Chairman, I believe it is time to renew, refocus, and broaden the mission of the GSEs. I believe the first step in doing so requires the adoption of a new regulatory framework as outlined in your bill.

With respect to their mission, I would like to see the GSEs become much more active in the low end of the housing market. And it is really surprising how all members of this panel have agreed with that part of the GSE mission.

Now that might involve lowering the current Freddie/Fannie maximum loan limit from its current level of $227,000 to perhaps something like $127,000. That would really force them to focus on the low- and moderate-income sector of the market.

As Mr. Nader mentioned, needs in the affordable housing area are very, very great. I will just quote one line from a recent HUD study:

"The housing affordability crisis facing very low-income renters continues to worsen as 5.4 million renter households, a record high, are experiencing worst case needs for housing assistance." Clearly, there is work to be done there.

And also, in looking for a new, broader public mission for the GSEs, I suggest that this Committee think about having them focus their attention on housing markets populated by minorities and women.

Devoting even a small percentage of GSE mortgage financing activity to markets populated by persons of low- to moderate-income, minorities and women, will help even the distribution of income and wealth, contribute to domestic, political, and economic stability, and will earn its investors competitive returns.

It is again my belief that investors, women, and minorities and the country in general, are well served by these types of targeted investing efforts.

Further, I believe it is possible to create targeted mortgage investments and portfolios that perform well financially and address social concerns. I have personally uncovered many investment opportunities of this type.

Let me take a second now and describe one such investment opportunity. Prior to joining the Board of Pensions of the ELCA in 1999, I served as CEO of Creative Investment Research, an independent investment research and management firm that I founded in 1989.

The firm specialized in socially responsible investing. My background in finance and investing led me to develop several socially responsible community investment products.

One of these was a set of mortgage-backed securities originated by financial institutions that were owned by minorities and women, serving areas of high social need. As noted in *The American Banker Newspaper*, I was the first investment advisor to create such a pool of mortgage-backed securities, comprised entirely of loans from minority and women-owned financial institutions.

Working with G.E. Capital, I identified minority-owned lenders willing to participate in the program, arranged G.E. Capital's participation as the aggregator of the loans originated by these minority financial institutions, and worked to place the MBS pools with a socially responsible institutional pension fund.

Now let me turn to some of my social investing concerns, to some of the concerns that I have with the GSEs. Given their public purpose and mission, social investors have long believed Freddie and Fannie to be positive investors and good corporate citizens.

In the main and for the most part, they are. But I have been troubled by certain aspects of GSE corporate behavior.

I am deeply concerned with the recently issued report on GSE home lending to minorities. The report issued by HUD showed that in 1998, quote:

"The share of GSE mortgages going to minorities trailed the National average of 15.3 percent. Fannie Mae lent only 14 percent, and Freddie Mac lent only 12.2 percent to minorities. The disparity is even more pronounced in mortgage-lending activities to African Americans. While the total market for mortgages to blacks is 5 per-

cent, Fannie Mae only lent 3.2 percent and Freddie Mac only lent 3.0 percent."

Now I believe I can explain this data. A history of discrimination has created a lack of data on black borrowers, making it harder to predict which factors affect repayment performance. Cultural and community factors may also affect loan performance.

It is unlikely that the GSEs have an ethnically neutral set of evaluation criteria. Lacking an ethnically neutral set of loan evaluation tools, both Freddie and Fannie lent relatively fewer dollars to African Americans than others did.

In essence, the GSEs may have incorrectly assessed home mortgage lending risk in minority markets and communities. By reducing the flow of mortgages to minorities, the GSEs may have ignored profitable lending opportunities.

This behavior in and of itself reduces GSE income and stifles the flow of mortgage credit. I think we can all agree that this is contrary to their congressionally-chartered mission.

You know, we have seen other financial institutions repeat this type of behavior. On October 22nd, 1998, Freddie Mac board member and economist Henry Kaufman, speaking of the Russian financial crisis noted in *The Washington Post* that, quote: "All of the problems pervading Wall Street just cannot be blamed on outside forces. Institutions have incorrectly assessed risk. If they had one their due diligence, a lot of this"—and he was speaking of the Russian financial crisis—"mess would not have happened."

Likewise, all of the uncertainty that Freddie and Fannie now face cannot be blamed on outside forces like Congress, HUD, or incorrectly interpreted statistics.

I agree with Fed Chairman Greenspan when he says, quote: "The history of financial involvement in increasing home ownership is one of taking risks, of designing new financial instruments and financial products to make financial resources available so that more people can realize the goal of home ownership. Taking prudent risks in lending so that others may attain an objective is the essential role of a financial intermediary."

I suggest that the GSEs renew their involvement in the home ownership process by designing new financial products tailored to the needs of home buyers in the low end of the market, enabling and facilitating others as they take the prudent lending risks outlined above.

Again, both Freddie and Fannie dispute the HUD numbers. I expect the debate concerning GSE performance in this area to be a lively one.

However one views the statistics, however, we can all agree that much remains to be done.

Some of my other concerns surrounding the GSEs and their public mission basically revolve around their seeming reluctance to acknowledge that Congress, in fact, has a legitimate role in reviewing their activities, both from the standpoint of financial safety and soundness and with respect to the performance of the GSEs in carrying out the public mission for which they were chartered.

I note that, Mr. Chairman, you really have been examining GSE activities since at least 1996, and I think they have become a little

better behaved in their approach and attitude toward Congress, so I want to thank you for that.

Now, Mr. Chairman, I would like to turn to your legislative proposal.

Number one, in terms of promoting market discipline I support repealing the GSEs' conditional line of credit to the Treasury.

I agree with Treasury Undersecretary Gary Gensler when he stated in testimony before this Committee on March 22nd of this year that "repeal of the line of credit would be consistent with the congressional requirement that all GSE securities carry a disclaimer that they are not obligations of the U.S. Government."

Let me turn to increasing transparency. I also support the provisions of the bill that increase transparency. I support requiring that the GSEs receive an annual credit rating from a nationally recognized statistical rating organization.

Such an examination would significantly improve transparency by providing an independent and objective opinion concerning the GSEs' financial condition.

One proposal I would like to make, however, is I would like to suggest that the GSEs be subject to a social audit. A social audit is an examination of the performance of an enterprise relative to certain social objectives.

The GSEs are currently subject to a limited social audit. Central city and minority lending goals have been established, and progress that the GSEs make in meeting those goals is reviewed on an annual basis.

I am suggesting, however that the GSEs be subject to a much more detailed and rigorous social audit covering all aspects of their operations.

Congress may want to specify—this Committee in fact may want to specify in detail which social objectives could be measured. But that is certainly a tool that we are seeing in the social investment field that is becoming more and more of a standard tool. And that is where corporations are subject to a social audit.

For the GSEs, the major benefits of a social audit are:

One, improved accountability with respect to social and community investment activities.

Two, increased social efficiency and effectiveness.

Three, increased ability to effectively monitor and steer social performance;

And finally, social achievements of the GSEs can be reported in an unbiased manner.

Finally, I support the provisions——

Chairman BAKER. Mr. Cunningham, if I might just suggest. I have given all the witnesses pretty good liberty in the length of their testimony. If you can begin to move toward summary, that would be great.

Mr. CUNNINGHAM. Certainly. I appreciate that, Mr. Chairman. Basically, I certainly support provisions of the bill to encourage market competition.

Lastly, let me conclude by saying, in an interdependent financial world with capital and information flows often determining the short-term fate of nations, it is entirely appropriate for this Committee to review the proper role and function of the GSEs.

Given the speed with which capital market destabilizations can occur, as shown during the Long-Term Capital Management incident, the creation of a strong, unbiased, and politically independent GSE regulator is essential.

As many who have come before this Committee have noted, domestic housing and finance markets are currently broad and well functioning.

These markets have been the beneficiaries of an unprecedented increase in financial market activity and asset values.

GSE shareholders have profited greatly as a result. Now is the time to review GSE financial and social performance.

By doing so, we are likely to ensure that GSE shareholders continue to prosper and to ensure that the Nation continues to enjoy the world's best housing finance markets.

This Committee has done the country a great service by focusing public attention on the GSEs. In this way, the Committee continues to meet its obligation to enhance the long-term stability of the U.S. financial system. I applaud you all for doing so in a balanced and thoughtful manner.

Thank you, Mr. Chairman and Committee Members.

[The prepared statement of Willaim M. Cunningham can be found on page 256 in the appendix.]

Chairman BAKER. Thank you very much, Mr. Cunningham, for your appearance and your thoughtful testimony. It is clear your Mom's hand was evident in your performance and she is to be highly commended.

[Laughter.]

Mr. CUNNINGHAM. Well, thank you, sir.

Ms. JONES. Mr. Chairman, before you proceed with questioning, we have seated in our audience today a former Member of Congress who served on this Committee for twenty years who has sought to testify in this hearing today.

I would request that former Congressman Walter Fauntroy be permitted to testify today with regard to this particular issue. I think he has a lot of experience and ought to be permitted to testify this afternoon.

Chairman BAKER. I thank you, Mr. Fauntroy. Welcome to the hearing room today. Having served with you on this Committee for some time, I certainly appreciate your knowledge and insight.

What I might suggest, Ms. Jones, if it is acceptable to your side, is that we proceed with our panels as scheduled and at the conclusion of those panels if former Member Fauntroy wishes to come forward and make some remarks, I have no objection to that.

Ms. WATERS. Mr. Chairman, I would agree with my colleague. And while you are very generous in offering that he be able to do that at the end of this, I would ask unanimous consent that you allow him to not have to sit through the entire hearing, because I know that he is scheduled for some other appointments later on. So I would ask you to continue your generosity and let him come a little bit sooner than that if it is——

Chairman BAKER. I will tell you what I will do. I will give the gentleman a couple of a minutes now, and then I will offer him a full opportunity to be heard in entirety. We are not going to be

here much longer unless Members choose to drag the hearing out. We have a very short panel that follows. And everybody in the room has obligations.

But, Mr. Fauntroy, if you would like to come up, I will give you two minutes to make some comments at this point, and then we would recognize you for a full panel opportunity later in the hearing as well.

Ms. WATERS. Mr. Fauntroy—if I may, Mr. Chairman—my staff will assist you with your appointments that you have later on if you would like them to make some calls for you if you would like to stay.

STATEMENT OF HON. WALTER E. FAUNTROY, FORMER DC DELEGATE, U.S. HOUSE OF REPRESENTATIVES; HEAD, NATIONAL BLACK LEADERSHIP ROUNDTABLE

Mr. FAUNTROY. Thank you, Ms. Waters and Mr. Chairman.

I do want to thank you for this opportunity to appear before the subcommittee, and I will briefly summarize at this point. But I do want the opportunity to present the full weight of my testimony. As you know, that testimony——

Chairman BAKER. If you have a written statement, it will be included in the record.

Mr. FAUNTROY. And I would like to elaborate upon it beyond the summary I am about to give you.

And that summary begins with the fact that, as you know, I spent twenty years on this committee shaping in the decades of the 1970's and 1980's much of the legislation that has been of great benefit to people in low- and moderate-income range of our country.

I came to this committee against the background of a tremendously effective bipartisan effort to demonstrate in the District of Columbia how all available Federal and local programs might be coordinated and concentrated to deal with the crisis we had in this city and in the country thirty years ago.

It was a crisis of a disappearing stock of housing for low- and moderate-income people.

I had the great privilege of being sponsored by President Johnson and then President Nixon in fashioning the Shaw Urban Renewal Area, which delivered to church or faith-based organizations in cooperation with the local and Federal Government an opportunity to provide, in fact, literally thousands of units for low- and moderate-income people, many of them, most of them, home ownership opportunities.

I wanted an opportunity to share some views with this subcommittee on the basis of the fact that the crisis which we experienced thirty years ago is even more severe now.

Mr. Cunningham has just mentioned the report of HUD to the Congress on the worsening crisis by which some 5.4 million families are going without access to affordable housing now, and that problem is reflected most acutely right here in the District of Columbia, where we have a waiting list for opportunities for Section 8 housing, for example, that is about 10 times that of the average in the Nation.

And I simply wanted to make some suggestions as to what we need to do, not simply to see to it that the GSEs carry out the mis-

sion for which you passed a very effective Act in 1992, but that we fashion in the District of Columbia an instructive example of the kind of bipartisan coordinated and concentrated effort necessary around the country to deal with this crisis about which I am sure you are all familiar.

May I simply add in closing these summary remarks that certainly there are things which the GSEs need to do better.

I am so delighted at what happened in 1992 here, shortly after I left the Congress. I was more pleased about what happened in 1998 when you passed the Asset Control Areas Partnership Act, which has created a number of opportunities that I think need to be seized upon now by the kind of bipartisan concentrated effort that had President Nixon praising what we were doing even after President Johnson had left the scene.

With that, Mr. Chairman, let me again thank you for this opportunity and the congressional courtesy afforded a former Member of the Congress who worked so closely with so many of you at very critical points in your effort on this Committee who must lead the Nation in shaping effective policies.

[The prepared statement of Hon. Walter E. Fauntroy can be found on page 262 in the appendix.]

Chairman BAKER. Thank you very much. And I will extend the open door policy as well. If you would like to come by and visit with me on your concerns, that certainly would be a welcome opportunity. I look forward to visiting with you.

To that end, I observe that all of the witnesses' remarks today—I, of course, reviewed the written testimony—but your oral presentations were frankly exceptional, and I want to commend each of you for your willingness to appear here.

This is not an easy political subject for discussion. I would suspect that most Members of this Committee at some point during recent months would have wished the number 3703 would just disappear. But your remarks have been most constructive, and I wish to commend you for your willingness to stand up and make the respective observations.

Further, in response to the comments of the former Member that we reach out and try to do more in addressing the needs of housing in this country, H.R. 3703 I hope will not be viewed simply as a tool for enhanced taxpayer protection, which it clearly is, in my view, but also a tool for enhanced opportunities for housing. And I would observe that those two goals are not mutually exclusive.

In fact, I took note of—well, Ms. Roukema has stepped out. In her opening remark, she made some indication that mission compliance in the line of credit might have an interesting relationship. Some of you have made similar observations.

Particularly you, Mr. Taylor, when looking at whether the line of credit should be made available, whether it be Mr. Raines, Mr. Brendsel, whoever the participant might be, all have commented from a business perspective, the line of credit is purely symbiotic.

It does not equal one week's worth of trading. It is used to market the securities on favorable terms to investors. That is it.

If we are to discuss discipline, I had suggested, pursuant to the introduction of H.R. 3703, that the repeal of the line of credit be

tied to an S&P rating. Again, coming at it from a capital adequacy concern.

I would be willing to consider modification of the legislation, perhaps to the amazement of some of my friends, to do exactly what you suggest, Mr. Taylor, but tighten it up a bit.

Where you suggested we look at their mission compliance over a two-year clock based on HUD goals, let us call this thing the way it is.

There will be testimony later this morning that the updated value of the subsidy in today's market is at least $10 billion. That is a pretty expensive program.

Imagine what some folks could do with $10 billion in communities in the work you do. How about we talk about the fact that a third of that subsidy, by some estimates, flows through to shareholders, two-thirds does get to homeowners, but then we look at where the loans are actually made, as Mr. Skillern pointed out, it does not always result in the low-income individual being the beneficiary of the lending activity.

H.R. 3703 is not in concrete. It is a work in progress.

I would be willing to incorporate every recommendation that you made, Mr. Taylor, perhaps with the discussion of organizational structure of the regulator from a safety and soundness perspective, leave mission compliance in HUD, and add one additional thing to modify your proposal. In other words, I am seeing you and raising you one.

And that is, we should not expect an organization which benefits from a governmentally-granted charter, which is so enormously expensive to follow the market.

All of your data indicates that the GSEs do not match the performance of commercial financial institutions in your respective neighborhoods. I think they have the obligation to lead the market.

They are innovative. If they can figure out how to finance aluminum siding at Home Depot, they ought to be able to figure out a way to finance low-income home purchasing availability better than the folks who are not getting the subsidy.

My point is—and I would like to get your reaction across the board—what if we tied mission compliance to the line of credit, which is only used for marketing purposes, has no effect on safety and soundness, and to say "if you do not lead the market by whatever that number is"—we will argue about the HUD numbers, whether they are high or low—"and if you do not do what the Congress has said you must do in mission compliance, there goes your marketing tool."

Mr. Taylor.

Mr. TAYLOR. Well first off, Mr. Chairman, thank you. I do want to thank you for considering our recommendations and that they might find their way into your bill.

I do not want you to assume, however, that the current recommendations, that all the recommendations in your bill are necessarily supported by the National Community Reinvestment Coalition.

We are, I think, in concert here on this panel that we would like to see Fannie Mae and Freddie Mac do a lot more in lending to un-

derserved communities and underserved populations. That is the common bond, I think, of the panel up here.

To the extent that H.R. 3703 can have the influence of forcing the GSEs to do more, this would be a good thing from our perspective.

The idea of tying the line of credit to the performance, I think, is a good one in the absence of any other leverage, it seems, other than these goals.

We set these goals, and the fact of the matter is that Freddie Mac finished second in a two-man race for the last six years in a row. And some of the time they did not even achieve the goals that we thought were fairly reasonable goals put out by HUD, by Secretary Cisneros and then Secretary Cuomo. They did not even achieve those goals. And the penalty is? Nothing.

Chairman BAKER. Well, I think the point is clear. Many Members of this Committee are strong advocates for housing opportunities for low-income individuals.

I consider myself to be modestly on that side of the ledger. And we seem to have created an enterprise that is supposed to facilitate that.

It would seem clear that after thirteen years of back-to-back double-digit rates of return to shareholders when interest rates have gone up or down, and when you look at the performance that each of you have indicated from your various perspectives has not even kept up with traditional private market participants, this to me seems like an opportunity worth great exploration.

Now, I understand you may have other problems with H.R. 3703 on this or that.

Mr. TAYLOR. Yes.

Chairman BAKER. But let us focus this hearing on mission compliance and how we make it work. And I think the leverage within the board rooms of these organizations to find creative ways to meet needs in local communities would be accelerated at a rather stellar rate if the marketing tool associated with their advantage in the marketplace would be put in jeopardy if they simply do not meet what is a reasonable standard.

Mr. TAYLOR. Mr. Chairman, if I may, I testified before you a few weeks back at the Financial Institutions Subcommittee hearing on predatory lending that Chairman Leach held. And at the time you made a comment that you did not see what the problem was with subprime and predatory lending.

I think for us, at least from my perspective, to move forward, we need to work closer with you to understand the depth of the problem of predatory lending in your State and every State in this country, and how subprime is becoming the loan of choice, and oftentimes, the only available choice for people, as you heard from Mr. Skillern, in his example, not only A-quality borrowers, but disproportionally, people of color.

We have got to reach some consensus that that is a real problem, because the GSEs play a major role in that and will increase their role in the coming years.

When I served on the Freddie Mac Housing Council, they presented a report to us that showed that nearly 50 percent of the

subprime loans that they purchased were from people who should have gotten A-quality paper.

So in effect, we have the Government-sponsored enterprises creating a pipeline for a more expensive, unfair, possibly jeopardizing kinds of loan products for the people who can least afford to pay for it, the low- and moderate-income people.

We would like to see you perhaps reconsider some of your positions that you took at the previous Committee hearing, and I mean that—I do not mean any disrespect.

Chairman BAKER. No, and I agree with you that my comment actually at the prior hearing was.

Define predatory lending for me, and tell me where it is occurring, and I will sign the bill that cleans it up.

I am still of that position today. And if we can define the problem areas, I have no problem in providing those cures in H.R. 3703 if the Committee chooses to adopt them.

What I am saying to you is our directions are not as diverse as some outside observers might choose to indicate. There is a marriage of principles that will yield benefit to the taxpayer and to the low-income home buyer, and I think we can get there.

Ms. Roukema, I might just point out, I referenced you earlier because of your comment relative to mission compliance and line of credit, and that is what I was exploring with the gentleman in your absence.

Ms. ROUKEMA. Thank you. I was going to say that I did not have any further questions, because you had really pursued my line of questioning.

Chairman BAKER. Terrific. Thank you.

Ms. ROUKEMA. Thank you.

Chairman BAKER. Mr. Kanjorski.

Mr. KANJORSKI. Thank you, Mr. Chairman.

Mr. Taylor, touché.

It seems to me that we are about to legislate the cure for cancer. It seems to me that all we have to do is pass some law and we are going to cure this housing problem. In listening to all your testimony, and in particular to your testimony, Mr. Taylor, it is a process problem.

A person who has an “A” credit rating either has the capacity, should have the capacity, or should get the representation to get into the proper channel. I do not think the Congress is going to be able to do it. I do not think HUD is going to do it. I do not think a new regulator is necessarily going to do it either.

I am not sure what the outreach of a significantly sized organization like Freddie Mac and Fannie Mae can do in the marginal areas of 5 or 10 percent of home buyers that are abused. There is no question we should not have abuse.

But it is most interesting for me to listen to the testimony today from the panel criticizing the people that are performing a mission, perhaps not satisfactory to all. Certainly to legislators they never will be satisfactory.

But so often, home ownership and economic opportunity run together. And for us to sit up here and take positions that seem to be enlightened in fostering home ownership, positions that do not

recognize economic opportunity as a challenged area in our society, is just wrong.

I think we have an opportunity with some of these organizations to increase their mission in the economic development area.

I, for one, recognize that there are many areas of this country that cannot take advantage of all the housing programs we construct from now until doomsday unless we create the required earning capacity in certain elements of the American population. This Congress for several years has ignored this need, and, to some extent, has continued to limit it.

On the other hand, we are attempting to say that we are all for home ownership and that all we need to do is pass one piece of legislation to fix this problem. I say nonsense. Shame on us for trying to mislead the American people that way.

I have been asking, Mr. Chairman, for a number of months now, that we use these hearings as an opportunity to open up a major issue that should be discussed not only before this Committee, but in the context of the Presidential and Congressional elections this year. That way, the American people can participate in the broad process of national policymaking.

Clearly, one of the ways of doing that is not to have these panels appear before us periodically with vetted, and sometimes slanted, testimony.

And quite frankly, some charges have been made here by this panel against Fannie Mae and Freddie Mac that may or may not be true. I do not know. But, I would sure like to have them sitting at the same table with you responding to the allegations.

I have asked that we have roundtable discussions. I think we have to bring this issue to joinder, and we are not doing that. We are sitting here having one group present what their position is and how they analyze the market.

Quite frankly, something that really annoyed me at the hearing today is, that the free marketeers here today are saying that we have got to put out securities that are sound and that meet the criteria of the free market.

On the other hand, we are saying that we are not serving the underserved. Well, quite frankly, we are not serving the underserved, because the free market does not operate to serve the underserved. There is a need for a subsidy there.

Subsidies for housing aside, why do we not go back and honestly answer what the problem in America is?

We have an unequal opportunity for a large portion of American citizens that have been left behind for the last seven years in the prosperity that has developed in America.

Why does Congress not stand up to that and at least have those issues acted on? Now I know Mr. Nader would not be castigating the feeble attempts of the Democratic Congress in the creation of these institutions to give fair housing if he could castigate the present Congress' limited recognition of an economic opportunity.

But, if you were to take his testimony today and listen to it, you would think that he has joined another party.

[Laughter.]

Mr. KANJORSKI. I do not think that is the intention of his remarks today. I do not think that is the intention of anybody on this panel.

I think what I heard today is that a lot of the institutions created over the last twenty or thirty years have operated successfully, but now we are dealing with the extreme problems with economic opportunity, both in the minority and in the disadvantaged communities of America.

No matter how much we subsidize housing, if you do not give fair jobs, if you do not give fair income, and if you do not provide for investment in distressed communities, all the subsidized housing and all the sophisticated products that these GSEs produce are not going to solve the dream of American ownership within the confines of a market-driven security organization.

It is time that we put aside just talking about housing, and predatory lending, and all the other things, and determine where the problems come from and why they are there.

They are there because there is an unequal distribution of opportunity, particularly economic opportunity, for a large segment of the American people. It is time for Congress to establish a vehicle where we can sit around a table and have you make your charges or your propositions and ask the other side to respond to it.

I do not care whether it is the salary of an executive involved. I do not care whether there is an unfair opportunity of subsidy occurring. We must not address this matter with the idea that we have some magic silver bullet here encompassed in a piece of legislation that is going to cure America's need for housing opportunity for the disadvantaged of this country. That is a darn joke.

Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Kanjorski.

Ms. Roukema, you——

Mr. NADER. May I reply to that, please? Can I reply to that?

Chairman BAKER. I think it appropriate to give the gentleman a minute.

Mr. KANJORSKI. Oh, surely.

Mr. NADER. Well, the Congressman is always very good about broadening frames of reference. We could have talked about livable wage and repealing Taft-Hartley and progressive taxation on corporations without tax shelters, and all these other things that help to redistribute wealth.

In accordance with all the hard work people are engaging in in this country, 47 million workers make less than $10 an hour, some of them $5.25, $6, $7, $8. They can't buy much housing with that.

But one other thing I would like to add to the Congressman's broadening of our frame of reference is, when I was growing up in Connecticut, a relatively modestly paid textile worker could afford a six-room house and a second-hand car on a very modest wage, because the mortgage rates were 3 percent, a 3 percent, thirty-year mortgage. Now they are 8.25. And of course that has a lot to do with it.

Mr. KANJORSKI. Right. But let me extend that.

Mr. NADER. Yes.

Mr. KANJORSKI. When you were growing up, if that textile worker were getting the type of income today relative to what they were earning then, it would be considerably higher than it is today.

Chairman BAKER. If I may, because we have Members who have been patiently waiting to ask their questions. I do not want to cut you off. But let me say, on the other side of the coin, Mr. Nader, although Mr. Kanjorski's remarks were fully understood and appreciated, there are others on the Committee who would have a hard time questioning your commitment to consumers, just for the record.

Mr. NADER. OK.

[Laughter.]

Chairman BAKER. Ms. Roukema, would you choose to——

Ms. ROUKEMA. No, Mr. Chairman. I am going to pass. You really focused on the question that I had in mind, and I think given the numbers of people here and the second panel.

Chairman BAKER. Thank you, Ms. Roukema.

Mr. Ryan, you would be next.

Mr. RYAN. I look forward to the next panel.

Chairman BAKER. Let's see.

Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman.

A number of you endorsed provisions of the Baker bill. I know Mr. Cunningham talked about the idea of repealing the line of credit which Fannie Mae and Freddie Mac enjoy with the Treasury.

While the Chairman has been correct in stating that this is not in any way a full faith and credit guarantee, I think if you read any prospectus from Freddie or Fannie, they go to great pains to say "this is not a full faith and credit guarantee," and every broker or underwriter you talk to on Wall Street will tell you that it is not a full faith and credit guarantee, but the market treats it as something just less of a full faith and credit guarantee.

I think even if it would not cover one day, or one week, if there were a complete collapse of a GSE, I assume the market considers it that once the spigot is open at the Treasury, it would be rather difficult to turn it off.

I guess the question I have for this panel is, it seems to me Mr. Baker's bill and Treasury's position, quite frankly, of doing away with the line of credit and doing away with maybe some of the benefits that Congress has given to the GSEs over the years to foster their development, while at the same time putting a stronger yoke on them in terms of what they can and cannot do is a conflicting approach.

Perhaps the time has come to revisit what was done in, I guess, the 1970's. That is to say, instead of creating a privately held or publicly held private corporation that is Government sponsored, to just completely cut them off and send them on their way and eliminate any benefit they get and just say, "You are now completely on your own and you can do whatever you want to do. You are well capitalized. The Government is not going to stand behind you in any way, nor are we going to dictate as to what your mission is."

Would you find that acceptable? And then we would be through with this problem. The market would treat its debt accordingly.

They probably would downgrade it a little bit, as the Chairman mentioned. But they would be out on their own and Congress could say "We have washed our hands of this problem. The kids have graduated from college and we have sent them on their way to make it as they may in the world, and we have given them a little stipend to help them along, a good education. Hopefully they will become productive citizens of the corporate community as a result of that."

Would you all agree with that, or is it better to keep them under some form of lock and key or at least on a tight leash?

Mr. CUNNINGHAM. If I could respond to that really quickly. I think the issue here is one of balance. Undersecretary Gensler came in here on what, March 22nd? Made noises about repealing the Treasury line. And you saw what happened. You saw the turmoil that you had in the market, and that was just from the mere suggestion that Treasury might actually support this legislation in a way that Wall Street had not anticipated.

Now I worked on Wall Street for a number of years, so I would say that probably if you did that, if you made that a provision of the bill, the response in Wall Street would be immediate and negative.

I think that what is probably more appropriate from the standpoint of maintaining the long-term stability of the financial system is to basically make things plain.

Let us give Wall Street a schedule that says that in five years we will turn these institutions loose and they will be completely private institutions, or in ten years.

But, I think to basically do it overnight would cause some turmoil, mainly because of the level of guarantee that is out there, the level of the debt that these institutions have, depending upon whose numbers you use.

Mr. BENTSEN. And I am eager to hear the others.

But, Mr. Cunningham, it would seem to me that you would agree with that just on a phased schedule. But that would be contrary to what I think my good friend from Louisiana is doing in his bill. I think he is going halfway.

The concern I have got is you are taking a llama and turning it into what I remember from Dr. Doolittle is sort of a "push me-pull me" animal, and I am not sure of that sort of social engineering or economic engineering by Congress. And actually, you all are supposed to be saying that and not my side.

[Laughter.]

Mr. BENTSEN. But that is what appears to be happening. I would be eager to hear what the others have to say.

Mr. SKILLERN. I think housing advocates are concerned by that argument in that we would lose a tool that has been productive in creating affordable housing and opportunities and playing a corporate sponsorship with our nonprofits.

Our argument is not so much to lose that, but to build upon it. I think the concern of stripping away any type of Government accountability would mean that the market would just be more of the market; that I would be here testifying on what is not being done at all.

Second, Mr. Chairman, I liked your idea actually about exceeding the market as the benchmark. And I agree that I have sat around and negotiated with institutions, and I think that as an example, Freddie Mac has released CreditWorks, which is essentially a subprime product that is clean and is priced competitively.

But that is only $100 million worth of credit out there, and that just does not go far enough. If they were incentivized to be able to capture this market at a higher rate, that product would get a lot more than a $100 million line.

The other concern I had about your argument, though, was this idea of $10 billion in subsidy. Couldn't we do a lot with that in our communities?

And the answer of course is yes. But would we actually see that if you took away the charter? I am afraid what would happen is that that subsidy would just disappear.

So I will one-up you on your proposal, and say that the subsidy, if lost, is then set into a home ownership trust fund, which will then subsidize or make affordable second mortgages for Americans across the country.

We are really concerned that this argument against the GSEs are going to be used against.

Mr. BENTSEN. Mr. Skillern, I understand what you are saying. But if the effect of the Chairman's bill—and none of us know this; we only hypothesize this—but if the effect of the Chairman's bill is to raise the cost of capital to the institution, if it has that effect, would that not be counterproductive?

Mr. SKILLERN. I think that would be one impact, yes, sir.

Mr. BENTSEN. I do not know, Mr. Taylor, Mr. Nader, I do not know if you all have comments?

Mr. FAUNTROY. Mr. Bentsen, let me just if I may respond to your question as well, because I would be horrified if the scenario you laid out there became a fact.

It would leave the commercial banks as the only ones being subsidized in the area of housing construction and provision in this country.

I served for six years as Chair of the Subcommittee of this full Committee on Domestic Monetary Policy. And Paul Volker, who was then Chair of the Fed, taught me something that Alan Greenspan has confirmed to this Committee recently when he said that the commercial banks and thrifts have a 13-basis point subsidy from the Federal Government.

I understand that and I think he is an appropriate authority on this. But to take away the mission that we have sharpened, particularly in the last decade, that we gave to these GSEs would be a disaster.

Chairman BAKER. If I might, Mr. Bentsen, we have run on a bit over our time.

Mr. Sweeney.

Mr. SWEENEY. Thank you, Mr. Chairman.

I appreciate the opportunity, and I know we are rushed for time, because we have a vote. As you know—and I also have to leave, and I apologize for that; I have another hearing that I have got to get to—as you know I, like Mrs. Roukema and Mr. Kanjorski, really began this process, and others, began this process with a more

cautious approach, because I was concerned about the unintended consequences.

And really, I think, the first hearing said that if we operate from the principle of "if ain't broke, don't fix it," we are probably better off here.

However, I want to congratulate you for conducting these hearings, because I think they have served a great purpose in helping us to define and try to improve the GSE process in the market.

I really do, while some may not appreciate the value of these, I do. I also appreciate the differences we might have in sharing opportunities to all Americans that exist economically and certainly as it relates to the mission of providing affordable housing for all.

With that, I simply want to submit a statement to the record, if there is no objection to that.

[The prepared statement of Hon. John E. Sweeney can be found on page 219 in the appendix.]

Mr. SWEENEY. Your line of questioning on mission compliance intrigues me, and Mr. Nader's testimony as well as Mr. Taylor. We spoke about the role that HUD may or may not provide or perform, and I would like if we could have a very brief discussion from any of the panelists, but more particularly, from Mr. Nader and Mr. Taylor about that.

Is it your suggestion that in providing an expanded role for HUD that the role be an advisory role or, more precisely, a role of direction to the Board?

And how would you envision the sort of ongoing enhancement of mission compliance and HUD's role in that?

Mr. TAYLOR. Mr. Sweeney, obviously HUD has a role now. They have approval authority. I think what we are here to argue, and I would associate myself with the comments of Mr. Fauntroy and Mr. Skillern as it related to Mr. Bentsen's question.

We are here not to weaken Fannie or Freddie, but to strengthen their efforts in lending in underserved areas. I think to privatize would remove the leverage that we otherwise would have in that area.

At the same time, I think we need to—and part of moving forward for us is strengthening the oversight that HUD has, that that be a stronger body, that there be some tie, some penalty, some way to influence these institutions so that at least, you know, from our perspective—and unfortunately, I am not sitting up there—but from my perspective, that they do more in underserved communities.

I am concerned that we are having this great economic prosperity in this country, and now is the time where we can bring a lot more homeowners on board into the affordable home ownership market. But, we need some of these things, these levers, in place to help us.

Clearly, increased data disclosure is important in absolutely prohibiting their participation in any way, shape, or form in the predatory market, and seeing to it that HUD or whoever the oversight body is, looked at those items and looked at their commitment and compared them to the market and really had the ability to take action if, in fact, they were not performing at a level that reasonable people would agree it should be at.

Mr. NADER. In answer to your question, I would like to submit for the record a statement by Jonathan Brown on reform of GSE housing goals that was submitted at a conference here in Washington on May 23rd of this year.

In that testimony, he has a table based on GSE loan purchase data and HMDA loan origination data from the nine-county Chicago PMSA.

He shows that GSE market data by census tract racial category shows a decline in GSE market share from 75 percent in predominately non-minority census tracts to only 33 percent in census tracts in which minorities comprise 75 percent or more of the census tract population.

And in the Chicago PMSA, these two census tract categories represent almost 60 percent of the PMSA's total of 1,776 census tracts.

So the whole Federal chartering of Fannie Mae and Freddie Mac was to advance the housing goals for all Americans.

HUD, in spite of some nice statements by Secretary Cuomo, and the Congress, has not sufficiently supported a more rigorous public evaluation and enforcement of the purposes of those charters for Fannie Mae and Freddie Mac.

We are at such a primitive level that the executives of Freddie Mac and Fannie Mae will even dispute these figures. They have got their own map makers.

[The prepared statement of Jonathan Brown can be found on page 232 in the appendix.]

Mr. NADER. Now I think Congressman Kanjorski is absolutely right. We should have someone from Freddie Mac and Fannie Mae and Jonathan Brown, who worked sixteen hours a day on these maps for years, right up here so that never again do we hear the constant denial of what we believe is factual reality by executives of those two federally-chartered organizations.

I mean, if we cannot, you know, establish a factual reality, we cannot go forward on policy and we cannot go forward on enforcement.

Mr. SWEENEY. But the devil is in the details of how we are going to monitor the ongoing mission requirements. And it seems to me that the Chairman's suggestion of tying it to market standards and improving upon those market standards has great merit.

Where I began this process believing we ought not to tinker on the edges, I am coming quickly to the notion that maybe we have something here that we can reach some consensus on that can improve those mission statements and at the same time balance risks.

So, I thank you for your testimony. The information is very valuable, and the presentations were terrific.

I thank the Chairman.

Mr. CUNNINGHAM. If I can follow with one quick point on that.

Chairman BAKER. Very briefly. We have a vote pending.

Mr. CUNNINGHAM. Part of what we will be able to use going forward as we have seen on the social investment side is the technology that allows us to track large data sets very quickly these days.

I mean commonly, you know, people talk about the impact of the internet. Well this is one thing that we can use the internet to do.

We can use it to monitor the performance of the GSEs in meeting their social mission. I just wanted to make that point.

Thank you, Mr. Chairman.

Chairman BAKER. I thank you.

Gentlemen, we have a vote pending. We are about five minutes left in the vote. I know several Members still have questions for the panel. I ask your patience in remaining with us a bit longer.

We stand in recess pending the vote.

[Recess.]

Chairman BAKER. I would like to call our hearing back to order.

As I recall, Mr. Sweeney was the last Member to be recognized for questions.

Ms. Waters, in that case you would be up next.

Ms. Waters.

Ms. WATERS. Thank you very much, Mr. Chairman.

I do have a question I am going to ask of our panelists, but before I do that, I really need to make a few observations so that I can try and help everybody to understand where I am coming from.

I thank all of the panelists for being here today, and I thank you for the work that you do.

I am particularly delighted that Mr. Ralph Nader is here. He is always a breath of fresh air. And, you know, I have known him over the years, and he is on the cutting edge and very tough about it all. But let me just say this so that the panelists will understand.

I am trying desperately not to be used by anybody. There is this battle going on between FM Watch and the GSEs. It is all about market share, in my estimation.

Now I must qualify that so that my Chairman will not think I am casting any aspersions on him. I respect you, Mr. Chairman, and I sincerely believe that you are indeed acting on your sincere beliefs about problems that exist that need to be taken care of.

But, I believe that there is a battle going on and all of us should be careful not to get caught up in this battle about market share.

Some of the very words that are being used that I hear about, "mission creep," about likening what is going on with the GSEs to the S&L scandal, and so forth, are words that are in the internal documents of FM Watch as it developed its strategy about how it was going to attack the GSEs.

So I am very aware of that, and I have taken a look at the press releases that have been sent out by some of the groups that are challenging the GSEs and they use the very words that are used in the internal documents in its approach to attacking the GSEs.

Now having said that, in this battle I really am on nobody's side. I am, you know, a pox on everybody's house as far as I am concerned. And let me tell you why.

When you come here and you talk about whether or not the banks and the mortgage companies are doing better than the GSEs and you cite these slight percentage points, and you kind of tell me that the financial institutions are doing better, because they include in that assessment the predatory loans, and, because the GSEs have not really gotten into them yet that somehow the financial institutions are doing better, you have to understand—and I understand what you said, sir, and you made the picture very, very

clear as it relates to predatory lending and what the GSEs are doing and what they could be doing, and so forth—you have to understand that I do not think that lending and the availability of mortgages to poor people should be done regardless of the price.

I mean, some price is too high. And, as you said, it robs the poorest of the poor of the opportunity to use their dollars wisely and to have a better quality of life.

So unless we are talking about what we are going to do to deal with predatory lending and how we are going to get rid of some of the exorbitant fees that are charged, the unconscionable interest rates and the defaults as a result of this predatory lending, I do not want to hear the figures about the financial institutions doing better than the GSEs, because you have not told me that you excluded the predatory loans from the percentages that you gave me about how much better they are doing than the GSEs. Do you understand what I am saying?

Now having said all of that, I think there is room for some regulation, and I do not have any problems with trying to make sure that the financial institutions and the GSEs do a better job in low-income communities and minority communities.

That is why I am such a fierce defender of CRA. The regulators do not do a good enough job, and so we have something in law for these non-profits and CRAs to do a watch over them and to help us to identify what we can do better. All of what we are doing, these policies are kind of being turned on their head.

My Chairman, for example, is not a supporter of CRA. My Chairman, who is interested in making sure that there are more loans given in minority communities and in low-income communities, does not support the work of CRA to make sure that that happens.

It is interesting when I see the CRA groups here talking to my Chairman and the people who are advancing this cause of FM Watch about what they think is wrong.

I do not want you to get caught up in this market share battle between FM Watch and the GSEs. I want you to say the same thing that I am saying: "A pox on all your houses." I am not going to be used. What I think you ought to be doing is, just let the chips fall where they may.

Now having said that, did you give me in the percentages of the lending from the banks and the financial institutions, did you include their predatory loans in that information that you gave me, Mr. Taylor?

Mr. TAYLOR. Yes.

Ms. WATERS. Or did you separate it out?

Mr. TAYLOR. Thank you, Ms. Waters.

First off, I want to let you know that I in no way identify with FM Watch, nor do I desire to be caught up in the battle for market share, and it is not for lack of their trying to contact us.

Similarly, I have a lot of contact with Fannie and Freddie, and I guess I have a lot more faith, because I have more experience with them. But they understand where we are coming from as an organization, and that we will continue to push them, and push them hard in any way we can, to purchase more mortgages going to low-income, minority, and other underserved populations.

And toward that end, we did our own study, which in fact looked at home purchase lending in neighborhoods in different areas of the country. But in Pittsburgh, for example, banks' purchase of loans made up—just using Pittsburgh as an example—16 percent of all the low- and moderate-income mortgages made in that area.

Now remember, most of the predatory stuff happens in the refinance area. What we looked at—and why Fannie was critical of us—was because we looked at originations. Who is really going out there and making loans available? Not buying seasoned loans off the shelf that are already approved to be creditworthy and that sort of thing, but rather, who is making these originations.

And in that area, in Pittsburgh for example, the banks made 16 percent of their loans to low- and moderate-income people, while the GSEs did 3 percent. It is possible that some of those originations could have been predatory. One of the problems we have, and that is why——

Ms. WATERS. Excuse me, I am going to interrupt you for a moment.

Mr. TAYLOR. Yes.

Ms. WATERS. Because one thing that is very clear to us on this subcommittee is this, Mr. Taylor. That is that minorities and poor people are forced into signing off on predatory lending when they qualify for traditional loans.

It has been said here today, and it has been said over and over again, you get people who qualify, who you know whatever the income requirements are, whatever the credit records are, they qualify. But these same banks are pushing them into this predatory lending.

Mr. TAYLOR. Subprime. I think you are saying, and predatory.

Ms. WATERS. Subprime lending and predatory lending.

Mr. TAYLOR. You are absolutely right. And we, of course, testified to that effect. And one of the things that would be very helpful, and I think your point is well taken, is if we had more data.

I came here last time, and Chairman Leach lambasted the Federal Reserve and the other regulators for not coming forth with real solutions, and you, too, as well, Ms. Waters, and others from the Banking Committee.

The truth is, they have the access to the data. We do not. The general public does not.

Ms. WATERS. Did you make a recommendation that this be a part of this legislation?

Mr. TAYLOR. I certainly did, as strongly and as forcefully as possible.

Ms. WATERS. As part of this legislation?

Mr. TAYLOR. I did it at that hearing.

Ms. WATERS. Well, let me just tell you, and this is——

Mr. TAYLOR. But let me make a suggestion.

Ms. WATERS. No, no. Reclaiming my time. Reclaiming my time.

Mr. TAYLOR. OK.

Ms. WATERS. And this is what I am talking about when I say do not get caught up in this battle for market share. If you come here——

Mr. TAYLOR. I am sorry. I have to correct my comments.

Ms. WATERS. That is OK. Reclaiming my time.

Mr. TAYLOR. I did make a recommendation in my statement, and I apologize.

Ms. WATERS. Reclaiming my time. Reclaiming my time. I want you to come with recommendations regardless of the GSEs, regardless of FM Watch, about how to get at the problems and how to deal with getting more loans to low-income people and minorities.

Having said that, I cannot see your last name very well.

Mr. CUNNINGHAM. Cunningham.

Ms. WATERS. But I would like you to respond to that question.

Chairman BAKER. If I may, Ms. Waters, maybe we will come back to you on another round. You have gone over ten minutes, and I do have other Members.

Ms. WATERS. I appreciate that. Thank you very much, Mr. Chairman.

Chairman BAKER. Thank you, Ms. Waters.

Mr. Riley.

Mr. RILEY. Thank you, Mr. Chairman. And Mr. Chairman, I want to compliment you on the group that we have here today. It has been very enlightening. However, I have some real reservations about the way this testimony has gone today.

I think all of us want the GSEs to be a full participant and do more low-income loans, but I guess my biggest problem is who is going to be the final determinant to make those type decisions?

How do you judge the difference between the subprime and the predatory loan?

Where do we draw the line where we say that one is subprime and is something the GSEs should participate in, but another is a predatory loan that all of us seem to think should not even be available in the first place?

I do not know that I want HUD to be the one that makes that determination. And if HUD does not, who would?

Mr. Taylor.

Mr. TAYLOR. Yes, well, I think there are some obvious things, Mr. Riley, that are predatory that almost all reasonable people would agree upon—that there are loans that are designed to absolutely strip wealth, that on their face are designed to see to it that the person fails and that the broker or the person making that loan is going to own that property in a very short period of time.

Even listening to some of the subprime lenders talk to the Mortgage Bankers Association and others, they would agree that certain things done in the subprime field are really predatory and ought to be things that should be outlawed. Mandatory credit life insurance prepaid up front, things like that.

Where it gets gray, there are a lot of other areas, but there ought to be the ability for someone to assess and take a list and make a determination, a reasonable, intelligent person who is unbiased, to say these characteristics added up are, in fact, predatory. They are beyond subprime.

I do not think that is rocket science, and I do not think it is a difficult thing to do. But the will and the spirit has to be there.

And right now, there is not even the data for us. And that is why I have proposed in my remarks that we expand the data so we can take a look at this kind of thing.

Mr. RILEY. Well back to the original question, though.

Mr. TAYLOR. Yes.

Mr. RILEY. Once you have the data, once you have the ability to make that determination, who is going to be the final person that makes that determination on whether this is subprime or whether this is a predatory loan?

Mr. TAYLOR. OK. Good question. I would say it happens on a lot of levels.

Certainly CRA-regulated institutions should not be in the business of securitizing or making predatory loans. And the Federal bank regulatory agencies ought to come down on them with a big old heavy foot if they find cases where they are using the taxpayer's benefit of FDIC insurance and other benefits to be able to do this kind of unscrupulous activity.

Fannie Mae and Freddie Mac?

Mr. RILEY. And I think you are absolutely right on that point. But again, I think one of the reasons that you see banks participate more in low-income loans than probably a GSE is, because they do have other profit centers where they can offset some of the losses that they might have, and they also have the CRA language.

Mr. TAYLOR. I would not agree with that, sir. The record shows that mortgages made to low- and moderate-income people, whether you are looking at Fannie's or Freddie's or the Woodstock Institute's or almost any study, that the performance of low- and moderate-income people in the mortgage market is as good or better than other parts of the market.

Mr. RILEY. Then give me a reason why they do not have more——

Mr. TAYLOR. Fair Isaac and Company, the ones who are the gurus of credit scoring, for example, give negative credit for higher income in their credit scoring system, because they have found, through regression analysis, that lower-income people actually default less, and if they default, they have more of an ability—an empire does not collapse. If their mortgage collapses, they have more of an ability to go out and find another job and replicate the income needed to pay their mortgage.

So I would not go along with your assumption. And I think this is why, by the way, folks like Bear Stearns and the private, outside of Fannie and Freddie, secondary market entities are jumping to buy these CRA loans now, because they are highly profitable, not to mention a lot of low-income people, because of financial illiteracy, do not refinance and take advantage of the institutions and the systems that would actually help them.

Instead, it helps Wall Street and others make greater profits, and therefore, they love these loans. So I am not going down that road with you.

Mr. CUNNINGHAM. Well, let me, if I could really quickly jump in here, because I actually did some of the original work that looked at this issue with respect to mortgage-backed securities, loans originated by minority financial institutions including Family Savings and Loan in Los Angeles and Founders National Bank, Carlton Jenkins out there. Basically, what we found, again—and this predates John's work; this was back in 1990—what we found was that for exactly the reasons he stated, basically, low- and

moderate- income people, when they got the loan, worked twice as hard to maintain the loan.

Therefore, the prepayment rates on those loans—that is, paying that loan early—were lower than the prepayment rates on generic loans.

If the prepayment rates on a certain set of mortgage loans, a mortgage pool, is lower than the generic, that is worth a lot of money to Wall Street, because they can tailor and target the cashflows. They know with a greater degree of certainty what cashflows are coming in.

What happens, what has happened is what I talked about in my testimony earlier, and that is that the risks have simply been inaccurately categorized.

Mr. RILEY. Then based on those assumptions, I would assume that the GSEs are making a financial mistake not to go out and actively pursue this more on an economic basis and a monetary basis than on any other.

So can you give me a reason why they are at 3 percent and the banks are at 16? If this is a financial boon for——

Mr. CUNNINGHAM. Again, part of what happens is the GSEs use these very complicated models to determine what the probability of default is for certain individuals as the loans come in, and they build those models into their underwriting guidelines that they give to the banks to say, "OK, look, this guy, when he comes in and takes out a loan application is going to be an A credit, this is going to be a B credit, this is going to be a C credit."

Part of what happens is that the lending criteria that the GSEs have developed are not ethnically neutral. They are not neutral with respect to income and ethnicity of the borrower.

Now they would claim that that is not the case, but basically what I think John and I are saying and what the experience in the market has shown us is that there is a profitable sector that is being ignored.

Therefore, the only way to explain that unwillingness of the GSEs to go into that sector is to suggest that their underwriting criteria are somehow off. That is, that they do not correctly account for certain——

Mr. RILEY. And I guess that points up the real dilemma here when you have these hybrid organizations that are partly Government and partly private.

I am not too sure that this subcommittee has the expertise, and I am not too sure when there is a difference in the modeling between what you say and what the GSEs say, and it is a privately held company, that we should hold them to a standard that they do not believe that they can live with.

Chairman BAKER. Mr. Riley, if I can, we have been generous on time, but you are well over. Do you want to make a concluding remark?

Mr. NADER. May I just answer it very quickly? You asked a couple of questions, how do you determine predatory market and subprime lending?

I suggest one way is too look at the past when there were usury laws. Companies now are engaging in behavior, which before the 1970's would be considered criminal. But now the usury laws to

States have pretty much been repealed, and there is a long history about what the usury law assumptions of fairness are. So that is one.

The second is, the National Consumer Law Center in Boston has done a lot of good work in this, and you might want to contact them.

And the third is, talk to the neighborhood groups who are working in the housing area. Like here in the District, the Neighborhood Assistance Project, whose director is Reverend Hagler, who is in this audience, has an extremely sophisticated analysis to answer your question as to why the Fannies and the Freddies and the banks have been veering away from low- and moderate-income neighborhoods, and what solutions this Neighborhood Assistance Project has already engaged in in showing what can be done, in showing how it can be done in giving people affordable housing.

So, you know, whenever you look at a problem, it is good to see what solutions there are around. And you might want to contact that group.

Mr. RILEY. And I appreciate that, Mr. Nader. The only problem that I have with that is, again, who is going to determine which model is correct?

Mr. NADER. Well, remember, there are a lot of standards, and the states should do more prosecutions in this area. I mean, the rapacity of some of these exploitive mechanisms which have been on page one of the *Wall Street Journal* are so extreme.

There is almost no comparison in the 20th century. And yet the prosecution, willpower, and the budgets of the states are just not up to it. It is almost as if it is terra incognito to local prosecutors. But they have a responsibility.

Mr. RILEY. But as with most situations, you have extremes. And the example that you pointed out today was an egregious attempt. And no one has a problem with that.

But somewhere in the middle range between what is a subprime loan and what is a predatory loan, someone has to make a determination of where you cross that line, and that is my problem.

I do not know who is going to make that. If the GSEs do not make it, then does HUD make that determination? Does this Committee make that determination?

Mr. MANZULLO. Mr. Chairman, I hate to do this, but I want to make a point of order that we should keep the questioning to five minutes. This has gone on for three hours now. We are not even on the second panel.

Chairman BAKER. The gentleman's point is well taken. As best we can, Members have been patient who are still here.

Mr. RILEY. I thank the Chairman.

Mr. BAKER. Ms. Hooley, you are to be recognized next.

Ms. HOOLEY. Thank you, Mr. Chair. I have a question for several of the members of the panel.

Thank you very much for being here. This has been very helpful.

Mr. Nader, what do you think is the most egregious benefit that the GSEs receive?

How does that negatively affect the consumer and home buyer? And what would be the benefit of eliminating whatever benefit you think is the most egregious?

Mr. NADER. Well I mentioned them in the testimony. I do not want to take the time up just to repeat them. But there are two ways to look at the benefits.

One is, what is the quid pro quo? If the Government is going to in indirect and direct ways subsidize these corporations, what are we getting in return? What is the taxpayer getting in return?

And the second is whether these subsidies can be reduced or eliminated and still, given the fact that Fannie Mae and Freddie Mac have a lot of public subsidy built into their net worth over the years, still hold them to fulfilling certain housing goals, as the witnesses have described. That is the way I would frame it.

I think now they are so rich and so powerful that they can be held to these housing goals without basically having an implied bailout potential.

There is a fellow named Stanton who wrote a book about fifteen years ago on the really risk levels of Fannie Mae and Freddie Mac, and do we want to go through that route again?

I mean, do they operate in a way where they say "Uncle Sam will bail us out? We can have low ratios in terms of our capital," and so forth.

You know, that is what you have to ask yourself. I mean, are you ready for it if something happens? And if that is going to be the case, then you have got to hold them to a much higher standard than private corporations are held.

Ms. HOOLEY. But the question is, how will the consumers benefit if you eliminate those benefits? I mean, that is what I am interested in is how are we going to benefit the consumers?

Mr. NADER. Apart from the taxpayers, you mean? How are you going to benefit the consumers?

Ms. HOOLEY. How are we going to benefit the consumers?

Mr. NADER. Well if you withhold the subsidy, you benefit the taxpayers. The consumers relate to the housing goals of HUD and how that relates to Fannie Mae. Those are two different subjects.

Although you may have an additional point to make?

Mr. TAYLOR. I would not eliminate. I would use those benefits to leverage greater commitments and involvement in low-income and minority neighborhoods. That is my position.

Ms. HOOLEY. And how would you do that, Mr. Taylor?

Mr. TAYLOR. OK. I would do it in several ways. One way is to expand the amount of data that is available so we, the public, could really take a look at what is going on, as I stated in my testimony.

Ms. HOOLEY. OK.

Mr. TAYLOR. Second, I would make a stronger oversight body that really had some teeth. Not until Mr. Cuomo arrived did we really, in my opinion—and I have expressed this to the GSEs, I am not the enemy of GSEs—that it was not until he arrived that we really finally saw what we perceived in the community as—how do I express it, stronger oversight or leadership from HUD indicating to us that there was a new sheriff in town and HUD was paying attention to these goals, and the goals indeed were raised.

To Fannie's credit, they adhered to them, and said "we will reach those goals, we are supportive of them."

But, its impetus within HUD is giving them—I think the idea of tying benefits if you do not perform is key. I do not care how many

middle-income loans they buy, obviously it is important from a profit standpoint, and that creates some ability there. I care from that standpoint, but what I care about is if you are going to get benefits from the American public and from the laws on the books now, I want to be sure that the folks who are benefiting the most are the ones who have been most locked out and continue to be locked out of the housing system.

And so leveraging those benefits into higher goals, increased data, keep them totally out of the predatory market is imperative. I still have problems, and we do not have the time to get into it, about how much they are going to get into subprime market and how much Freddie is into it now and how they are enabling these subprimers to give what Ms. Waters was talking about, B and C quality paper to A quality borrowers. I mean, they should not be participating in that.

Those are the kinds of things that ought to happen as a result of these benefits.

Ms. HOOLEY. Well as you look at different kinds of regulation or different kinds of control, I mean, one of the suggestions in this bill is now we have one regulator.

And yet I look at the dynamic tension that can happen between two regulators, one very specifically for soundness and safety and the others very specifically for housing, and it reminds me of FAA where you had Federal Aviation, you know, trying to regulate an industry and trying to promote an industry at the same time, which made for a huge conflict of interest.

Do you see as a governing board if we do something different, how do you deal with that conflict of interest of the goals of a board, of a single board?

Mr. TAYLOR. Well, I do not think safety and soundness is in conflict with—whoever the Member was that said earlier, I think again it was Ms. Waters. No one is asking them to open the vault and throw the money into the street and give these mortgages away to people who are not going to pay.

Ms. HOOLEY. I understand that.

Mr. TAYLOR. So, I do not think affordable lending—and I think there is constantly a presumption from both sides of the aisle that when you loan to someone who is working class or poorer that somehow that is a less-safe loan, and I do not adhere to that. And I think you have heard testimony that that is just not supported by anything but people's imaginations. And so I do not think they are in conflict.

And look, we have the bank regulatory agencies. The Fed, the OCC, the FDIC and the OTS.

Ms. HOOLEY. Right.

Mr. TAYLOR. They all have not just safety and soundness, but CRA oversight and several other things that they are supposed to do.

You know, presumably the leverage between all those involvements in those institutions in those various areas should give each individual responsibility that they have in oversight more leverage with that institution.

So I do not know. I mean, my crystal ball is no clearer than yours. But we definitely would like stronger oversight. And I think

what I am hearing is people agreeing with the notion of wanting more done. How that occurs, what the body—we did not agree with a proposed body that looks like the Federal Housing Finance Board, or the specific proposal in the bill—we did not agree with those models. But we do agree with the structure of a single stronger agency.

Mr. FAUNTROY. May I suggest that one of the reasons this is the first time in ten years—in nine years, that I have troubled the Committee with a request to speak, is that I believe that there is time now for our making the District of Columbia a laboratory in which we work these things out.

I recall, as I said, thirty years ago, when people with good intentions put together urban renewal. And it turned out to be the urban removal of low- and moderate-income people from valuable downtown land all over the country.

Ms. HOOLEY. I have seen it happen all over.

Mr. FAUNTROY. And what we did was to say we will fashion an instructive example in the Nation's Capital where it is being most acutely experienced. And I cannot tell you, having been born here and having grown up in this city, the difference between Southwest now and what it was when I was a child, and to the extent to which those tools were used to deny low- and moderate-income people opportunity for affordable housing.

We worked out something here, and it was a wonderful laboratory in which Members of the Congress, the agencies looked at what is necessary. We got at that time such simple things as relocation services worked out because of that kind of experiment.

I want to see us, rather than debate and discuss the niceties of the problems in all of these agencies, to see if we can built on 1992, on your Act of 1992, which said, "HUD, you get in there and regulate this and put Fannie Mae and Freddie Mac and the District Government and Federal Government into a laboratory where it is most acutely reflected right now."

This is a crisis for low- and moderate-income people in gaining access to affordable housing anywhere in this country.

So, I would like to see us do it here first and together work on it. Then two years from now, let us have a hearing and see how it worked out right here where we can all see it. That is the burden of my recommendation pursuant to the question that you have raised and which I have placed in my testimony.

Ms. HOOLEY. Thank you. Mr. Chairman.

Chairman BAKER. Thank you, Ms. Hooley.

Ms. HOOLEY. Let me just make one suggestion, and it follows along with Mr. Kanjorski's. And that is that it would have been nice—and I think this panel has been terrific—but it would have been nice to have a mixed panel so that you can have that back-and-forth dialogue that I think is important when you discuss this issue.

Chairman BAKER. Well, I do not dispute your observation. I have thought about engaging—I was involved with a group, some Members were, the Bank Study Group where you do sit down and have people across the table.

But I would merely point out in some small defense of what we have done here today, this panel has now gone on over three hours.

No Member has been constrained. I think we have had excellent testimony. You may not all agree with the perspectives here represented, but I hardly think we can question the motivation and credentials of this panel.

As a matter of fact, I do not know if we have been able to resolve it yet, in deference to the gentlemen who have been waiting for the second panel, and in fairness to them and attendance of Members, we might well try to arrange for a subsequent hearing next week for the second panel and not continue on today.

Because I know Ms. Jones and perhaps others still have questions. But there is no rush, no intent to shield anybody out. I guarantee you, before we finish this process, everybody is going to be heard.

[Laughter.]

Mr. BAKER. Ms. Jones.

Ms. JONES. That is what happens when you are the least senior Member on this Committee. But I am diligent and I am going to hang in here.

Let me first of all ask: Mr. Nader, how many loans does a GSE originate?

Mr. NADER. How many loans?

Ms. JONES. Do they originate, yes.

Mr. NADER. None.

Ms. JONES. They do not originate any loans at all, and yet you accuse them of not giving loans to minority and low-income people?

Mr. NADER. Yes, but, I mean they are the precondition for the market working. If you ask them, they say that more mortgage funds are liberated from the banks around the corner, because there is a secondary market that they can lay these mortgages to.

Ms. JONES. What year was Fannie Mae and Freddie Mac created?

Mr. NADER. I think it was in 1937.

Ms. JONES. OK. And predating Freddie Mae or—I always get them confused, Fannie Mae, Freddie Mac—and to this date, they do not originate a loan, so the policy of lending to communities was not set by these two GSEs, it was set by the banking industry.

Is that a fair statement?

Mr. NADER. Of course. Because they were not existent at that time.

Ms. JONES. OK. And historically, if you follow through on that, because we deal with precedents in this country, the rules and regulations with regard to lending are not the policies of the GSEs, they are the banking policies. And much of what you want to lay on them originates with the banks who have no Government regulation as compared to the GSEs or no Government subsidy, right?

Mr. NADER. Well, you should hear our testimony on the banks. This was not a hearing on the banks. This was a hearing on how to regulate Freddie Mac and Fannie Mae. But we have testified about——

Ms. JONES. I am asking the questions. Just answer my question.

Mr. NADER. Right.

Ms. JONES. The answer to my question is?

[Pause.]

I was here for the banking hearing, but my question is, in fact loans are originated by banks from—the loans are originated by banks and so Freddie Mac and Fannie Mae do not have any control over that portion of it, correct?

Mr. NADER. Sure they do. They have incredible leverage.

Ms. JONES. OK.

Mr. NADER. In fact, they admit it.

Ms. JONES. I see you do not want to answer that question. Let me——

Mr. NADER. No. They admit it. They try to say they are going to do some good things to reduce subprime lending and predatory lending. So obviously they admit they have enormous leverage.

Mr. TAYLOR. Mrs. Jones.

Ms. JONES. Mr. Taylor, I have another question for you, sir.

Mr. TAYLOR. Do you want me to comment on that one?

Ms. JONES. No. I do not have enough time for you to do that.

Mr. TAYLOR. All right. Sorry.

Ms. JONES. OK. What I wanted to ask of you is, and I want to follow back on something that one of my colleagues, Mr. Bentsen, talked about. You said that you do not want to move to there being no Government subsidy of GSEs. Is that correct?

Mr. TAYLOR. That is not correct.

Ms. JONES. You want to move where there is no Government subsidies of GSEs. Is that——

Mr. TAYLOR. No, I do not want——

Ms. JONES. I said you do not.

Mr. TAYLOR. Right. I do not. Sorry.

Ms. JONES. It is the cross-examination lawyer in me that kind of gets witnesses confused I guess, but I do not know.

Mr. TAYLOR. That is OK. I am an attorney, too.

Ms. JONES. OK.

Mr. TAYLOR. But, I am for the subsidies as long as it continues to leverage increased purchasing of affordable mortgages in underserved communities. So I am for it.

Ms. JONES. And so in order to do that, what do you propose be done?

Mr. TAYLOR. OK. I propose——

Ms. JONES. Short answers.

Mr. TAYLOR. Sure. I propose stronger oversight, increased——

Ms. JONES. By?

Mr. TAYLOR. By HUD.

Ms. JONES. OK.

Mr. TAYLOR. Or a single agency.

Ms. JONES. OK.

Mr. TAYLOR. With power. I propose——

Ms. JONES. Power. What would that power——

Mr. TAYLOR. Influence, that they can influence—can I give the sort of the things, then I can go through each one so I can answer your question fully before you run out of time?

Ms. JONES. You have one minute.

Mr. TAYLOR. OK. So increased oversight authority.

Absolute forbearance from any involvement in the predatory lending market.

And then closer oversight of what they are doing in the subprime.

Increased data disclosure so we can see what they are doing, the folks that they are buying from, what those loans look like.

So those are the major points that we have put forward here.

Ms. JONES. Now some of what you want to lay on the GSEs, for example, allows them to be competitive, because we do not require private industry to be so open in disclosing some of the things that they do in the banking area.

Is that a fair statement?

Mr. TAYLOR. We are trying for that as well, Ms. Jones, in the other hearings and other testimony we have been asking for increased disclosure. That is where we are coming from.

Ms. JONES. I know what you are trying for, but the question is, we do not require it currently, right?

Mr. TAYLOR. Well——

Ms. JONES. And would that not put these GSEs at a disadvantage in the market?

Mr. TAYLOR. Well, would it put them at a disadvantage to disclose more of the data? Not necessarily.

But, we would argue that the private industry is also supported by the American taxpayer in the form of FDIC insurance, and that they, too, ought to be required to do the same.

So, as Ralph said, this is a GSE hearing. If we were here talking about banks, we would be saying the same thing, because we want real sunshine on what is going on in America's lending institutions.

In this case, we are talking about the Government-sponsored enterprises.

Ms. JONES. But, on the one hand, you want to argue that the Government-sponsored enterprises operate independently, but on the other hand, you want to argue that this is a whole operation of banking and Government-sponsored enterprises that allows affordable housing to proceed.

Mr. TAYLOR. You are like a prosecuting attorney.

Ms. JONES. I am a prosecutor.

Mr. TAYLOR. No. I would argue that, yes and yes. I think that the industry needs to be held accountable. But, because we are talking about the GSEs today, I am very focused on the GSEs.

Ms. JONES. I am, too, but you cannot operate in a vacuum. The discussion cannot happen in a vacuum——

Mr. TAYLOR. Here is the answer. You are asking——

Ms. JONES. ——Because we are not allowing—we are not imposing the same restrictions on the banking institutions. And when we talk about Mr. Cunningham, Mr. Cunningham, I think this is a heck of an idea to have social banking, but let's put it on all the banking institutions to require of them to do what you are talking about.

Mr. CUNNINGHAM. If I can follow up on that really quickly, because I have been involved in this debate ever since I worked for a guy named Andrew Brimmer, who was the first black Federal Reserve Board Governor. Basically, what I would like to see is a CRA standard that is applied across the board to all pension funds, insurance companies, banks.

Basically, the issue that we are dealing——

Ms. JONES. And how many people do you think would be at a hearing where we were going to propose that in a piece of legislation?

Mr. CUNNINGHAM. Well, I am not sure that I would want to be at a table if we were going to propose that.

[Laughter.]

Mr. CUNNINGHAM. And I am not sure I would want to start my car up if I was at a table where you were proposing that piece of legislation.

[Laughter.]

Mr. CUNNINGHAM. But basically, the way that the financial markets are going is that form does not really matter anymore, it is function.

I mean, it does not matter whether you are a bank or a thrift or a brokerage firm or an S&L or an insurance company. So basically, we have got to get—it is like they said, you follow the money; we have got to follow the money trail and make sure that those dollars—yes, ma'am.

Ms. JONES. Mr. Fauntroy, finally, what would you propose would happen in this area to make sure that affordable housing is available to communities throughout the United States?

Chairman BAKER. And if you can begin to summarize, but briefly.

Ms. JONES. That is my last question.

Chairman BAKER. Thank you.

Mr. FAUNTROY. As I said, I think this is such a complex question that what we need to do is something that I have been working with the Ranking Member, Mr. Kanjorski, on, together with some people at HUD and people in our faith-based community who are faced with severe consequences of the lack of focus by the GSEs, by the HUD itself on addressing this problem in the District of Columbia.

And if you will think of nothing more from my contribution to this, it is that you ought to look very carefully at a demonstration, a national demonstration project we want to implement right here in the District of Columbia, which is now on the desk of the Secretary and that has had the benefit of consultation not only with Fannie Mae and Freddie Mac, but the Federal Home Loan Bank Board and with Bank of America and others in the commercial banking areas in this area who recognize the time to talk about this is really beyond this. We have got to really do something about it soon in the District of Columbia in particular, but certainly among those 5.4 million families that are being left out that the report suggests is bringing this to crisis levels in the Nation.

Ms. JONES. Mr. Chairman, I would like to associate myself with the comments of my colleague, Mr. Kanjorski, and encourage us to have an opportunity to have all of the interested parties at a table to have this discussion.

Because really all we do in having a group of GSEs here one day and this group here another day is go back and forth and actually waste our time when we could really get somewhere if we were all at the table and used the power of the Congress to push this along.

Mr. NADER. I would be delighted to do that. We have always wanted to do that with Fannie Mae and Freddie Mac.

Chairman BAKER. I appreciate your recommendation.

I would just add in small response, I hopefully think some of the Members think these three hearings we have had to date have been somewhat educational and productive.

At least we ought to do our homework before we start taking the examination. And I think these hearings are the background for Members to become comfortable with the issues no matter what your perspective.

Certainly I have suggested a bank study group forum might be appropriate. But I will tell you that the room is going to have to be awfully big, and it is going to look a lot like a town meeting as opposed to a productive work session.

But I am not averse to any approach if it winds up with consumers being better served and taxpayers' risks being protected. Sign me up.

Mrs. Maloney.

Mrs. MALONEY. Mr. Chairman, I had to go to another meeting. I hope I am not going to repeat questions that were asked earlier, but I was struck by the conversation earlier on the statistics allegedly that Fannie and Freddie's loans are not going to minority low-income communities, because certainly one of the intents was to increase home ownership, which they have been very successful at. We are at an astonishing 70 percent of home ownership. But certainly to target people who truly need it.

And I think one of the problems that was pointed out was that we are not tracking the data appropriately; that there's two different—do any of you have any ideas of how we could track the data better so it is clearer?

Do you have any ideas on that so that we could really know what is going on?

Mr. SKILLERN. Part of the discrepancy between the GSEs and advocates in HUD has been the availability of data. The GSEs have their own set of what they are purchasing.

Advocates can only use the Home Mortgage Disclosure Act data. And we know that the HMDA data does not report all of the loans. We did a study that showed 26 percent of loans were not being reported underneath HMDA.

Therefore the GSE says, see, we bought loans that were not reported underneath HMDA. Our numbers are higher. And what we have argued is that, well, proportionately, the HMDA numbers are too low, too. There this portionality.

So we really need fuller disclosure and better sharing around the GSE data so we can do these better analyses. And I think Ms. Waters has a very good point also about trying to determine what is it that we are measuring as well: Prime, FHA, subprime, and where that gradation along that spectrum happens.

Mrs. MALONEY. Well I think that we should really come out with some guidelines so that we can get better data so that we know what is going on, but one of the things that came out at one of the earlier hearings that Mr. Baker had was the statement I believe by one of the GSE representatives that they are somewhat limited, because they can only purchase loans that the banks will sell them.

So if the banks are not—they do not give loans themselves. So if the banks are only selling certain types of loans, then they are limited in what they can purchase.

Would anyone like to comment on that?

Mr. SKILLERN. There is a correlation between the origination and what the GSEs are able to buy. Fair housing advocates argue that there is discrimination in steering right up front in the application process.

CRA advocates are concerned about location of branches and whether they are accessible to low-income people.

On the other hand, there is a correlation about what the underwriting standards are that banks are able to meet to be able to sell those loans to Freddie and Fannie.

If those underwriting criteria are prohibitive to making loans, then you are right. They cannot make the loans. So there is an interaction between the two both on the origination and then on the selling as far as its impact on low-income——

Mrs. MALONEY. So we need to look at what the program is or the criteria of what they will buy is what you are saying?

Mr. SKILLERN. That is correct.

Mrs. MALONEY. OK.

Mr. Nader—pardon me?

Mr. SKILLERN. I am sorry. We can expand that market of what Fannie and Freddie would be willing to buy with different underwriting and risk taking assumptions.

Mrs. MALONEY. OK.

And Mr. Nader, you cited census tract statistics on GSE mortgage purchases comparing minority and nonminority areas.

Aren't two reasons that the GSEs' purchases are lower is that these tracts, that many of these tracts are in areas where there are a high number of VA and FHA loans, and therefore they are where the loans are coming from?

And then also the fact that they apparently are limited by what the banks will sell of their loans. But the gentleman, Mr. Stillern, was stating that they package the program of what the loan's criteria are.

So could you comment on your reaction to those two areas that may have an impact on it?

Mr. NADER. Well the proper comparisons take those variables into account. And I can just refer you to the source of that data, who is Jonathan Brown, for elaboration.

Mrs. MALONEY. OK. And earlier also you referred to corporate welfare when you described the Government guarantee, the tax advantages, and a line of credit with the Treasury.

But banks also, those that are federally-chartered, have a guarantee of their deposits by the full faith and credit of the U.S. Government, and they have access to billions of dollars in the Federal Reserve's payment system.

Would you classify the benefits that we are giving to banks likewise as corporate welfare?

Mr. NADER. Yes. And you could have gone on with other examples. Yes. There is equal opportunity corporate welfare for these corporations from top to bottom.

The banks have had a very privileged position historically. And not only that, there is an implied assurance by the U.S. Government that if banks are big enough, they are going to be too big to be allowed to fail.

Mrs. MALONEY. I think that that is true of the GSEs too.

Mr. NADER. Oh yes.

Mrs. MALONEY. They are much bigger than banks, most of them.

Mr. NADER. Yes. Yes. No doubt.

Mrs. MALONEY. And I also would like to get back to the comments on predatory lending, which is probably one of the most important issues that is before this whole Banking Committee.

This increase in housing costs that we know that one of cited earlier that is really growing quite dramatically, will that not have an impact on the GSEs' announced predatory lending guidelines? The fact that housing is becoming more and more expensive?

Anybody?

Mr. SKILLERN. I am afraid I do not make the exact connection between housing cost and the impact on the guidelines. Could you clarify that?

Mrs. MALONEY. Well just it is just going to be harder and harder and harder to really get loans out to these communities to buy their own homes.

Mr. SKILLERN. I think that higher costs in the markets do affect demand, just like interest rates go up or the price goes up. Fewer people can afford to buy them.

The interaction with the GSEs, going back to Mr. Riley's comments earlier, the loan that I gave actually is not against the law, and it actually fits within the guidelines that the institutions have announced.

And so while he is concerned about the egregiousness of it, my point is is that we have to better define subprime lending as a useful tool, a tool that enables people to buy these higher cost loans that does not take wealth away from them.

I think there is an important role for the GSEs to play in the subprime market to expand home ownership opportunities through it, but the guidelines have got to be tighter and stronger before I am supportive of them actually doing it.

Chairman BAKER. Mrs. Maloney, if you can wrap up.

Mrs. MALONEY. Just finally, one last question. I will be very, very, very brief.

One thing about Fannie and Freddie that no one disputes is that they have been successful. They are tremendously successful.

One of the statements by Bruce Morrison from the Home Loan Bank at one of hearings earlier, he stated that people are coming from all these foreign countries to study what we are doing with the secondary mortgage market, because it has been so tremendously successful in providing home ownership.

But many of you have raised a point that some of the statistics are disputed; that it is not being directed to low and minority communities.

What if the guidelines or the programming which dictates whether or not they will buy the secondary mortgages were rewritten to direct it more to low-income families who are in tremendous need? What is your response to that?

Mr. TAYLOR. I think that is a good idea. Mrs. Maloney, I cannot speak for every panelist, but speaking for the National Community Reinvestment Coalition, we do think the GSEs have done a better job.

Part of it has been a booming economy, and part of it has been increased oversight by HUD, increased changes in laws from this Congress that have made a difference in inspiring them to do more.

But, the fact of the matter is, I am trying to avoid getting caught up in this FM Watch versus GSE problem.

I mean each side wants you to take a side. I am trying to be fairly pure in where we are coming from. But I work with a lot of banks who are not necessarily involved with FM Watch. When I say I work with them, I represent a trade association of community groups.

But, this is about trying to partner and collaborate and do things in underserved neighborhoods. And toward that extent, you try to work with lending institutions and try to get them to understand why this is a viable market and how to get into that market.

And if you were to listen to a lot of them, they will tell you in private that what Fannie and Freddie say in terms of their willingness to buy product is not exactly what the experience is with the lending institutions.

So, we go to Fannie and Freddie and say, "Hey, these lending institutions—we are not going to tell you their names—but they are telling us you will not buy this stuff."

And so finally, calling the bluff of both sides, we went to these financial institutions and we said, "Give us what is on your shelf, your portfolio of loans." And they were some of the largest financial institutions in this country.

We said, "Give us your portfolio of loans that Fannie and Freddie would not buy from you. We want to take those, and we are going to bring them to TransUnion and we are going to have them credit scored. And then we are going to go to Fannie and Freddie with that information."

And you know what they gave us? They gave us the tapes for $4 billion worth of mortgages that were primarily low-income, CRA loans sitting on the shelves of banks that Fannie and Freddie did not buy.

And we went to Fannie and Freddie and said, "Why aren't you buying these?" They turned around and they started buying them, which was good.

But, it was that incentive and encouragement that pushes them to do more. And why I am here, that is all I am here for, is to strengthen——

Chairman BAKER. Mrs. Maloney.

Mr. TAYLOR. I am sorry.

Chairman BAKER. I was just going to suggest, I know Mr. Kanjorski has additional follow-up questions. Can we move on?

Mr. Kanjorski.

Mr. KANJORSKI. I did not want to cut into Mrs. Maloney's time, but I wanted to make an observation.

This panel is in full agreement with the Majority side of this Committee that CRA should be extended to all financial institu-

tions, the GSEs, the insurance companies, the pension funds, and so forth. Is that correct?

Mr. TAYLOR. Absolutely.

Mr. KANJORSKI. So that is a remarkable occurrence.

[Laughter.]

Mr. KANJORSKI. Look, some of us have been critical of CRA, but not because we are against the principle or the objective of it. In many instances it turns out to be dressing and nothing more than that.

This subcommittee cannot reach into that and neither can the Executive Branch without getting so fundamentally involved in private sector operations that we would freeze the marketplace.

I know the Chairman wants to come up with some constructive mechanism to help the process. I hope that is what it is. And certainly I favor that, too.

I somewhat castigated the panel in some of my earlier statements, because I think we are addressing a very small segment of a problem here, and not recognizing the total problem in the country. Sometimes it puts some of you that have been supported by some of us in what appears to be contrary positions.

All I want to do is make sure the record is correct. I would like the panel to be more cooperative, if you will, in approaching that broader spectrum Mr. Nader talked about.

We are going to go all around here, and people are going to be taking bows in an election year, and I know this is not done for political purposes.

Chairman BAKER. That is a sure bet.

Mr. KANJORSKI. But we are really not going to get an opportunity to get direction from the American electorate to change national policy.

If we just concentrate on the failures of some of the existing institutions, already created by Government in a very big way, to accomplish and fill vacuums that for years existed in this country and continue to exist, we are going to be at cross purposes for good public policy.

It seems to me that I understand when one is asked to testify on a particular piece of legislation that one comes forward with that type of myopic view, but it sometimes sends a signal to the American people that we contend that if we just pass this one bill, we have solved all the problems.

Quite frankly, I tell you, I do not think this goes anywhere near doing that in your housing market or in the general opportunity field of the economy.

I hope that in the future Members of this panel will participate and that the Chairman will consider the opportunity. You know, maybe I will make an offer that we will try and see if the Minority side of the House has sufficient resources to rent a large facility, maybe the Kennedy Center, to put everyone concerned in there and have a discussion. Maybe we should lock us all in the room for eight or ten hours, and rather than posturing in some instances—particularly on this side of the bar—to really get at it and go at it and get some of the answers.

I am sure if we do that in a roundtable cross X debate, we will not have people asserting that one study says this when the other side says it did not.

Let them go at it and see the defects in the study or at least for our benefit to understand exactly what you referred to, Mr. Nader. Let us get to the real facts.

If we do not get the facts understood, if we do not get the sufficient data that my colleagues to my right have talked about, then we are going to be on this and give a false impression to the American people of how we solve this problem. We are going to end up getting the wrong directions from the electorate this November that will set the policies for the Executive Branch and for this Congress for years to come, policies to solve not only the housing problem, but some of the broader economic questions in our society.

Thank you very much, Mr. Chairman.

Chairman BAKER. Yes, sir, Mr. Kanjorski.

I want to make an announcement first before I make a concluding remark, and I am acknowledging I am going to make a few remarks, so I do not know if you want to hang around or not.

First I want to express my appreciation to the members of this panel for your extreme courtesy and tolerance in staying for such a lengthy set of questions. But I think it is evident that Members of both sides, all perspectives, have legitimate interest in hearing your views, and for that I am appreciative.

To the members of the second panel, Mr. Schatz from the Citizens Against Government Waste, Mr. Sepp of the National Taxpayers Union, Mr. Smith from the Competitive Enterprise Institute, I am understanding my staff has made contact with you with regard to the continuance of the hearing today, given the length of it and the fact that we want to make sure your testimony is heard by as many Members of Committee as possible, I have suggested in consultation with Mr. Kanjorski that we will simply recess this hearing until next Wednesday at 10:00 a.m. at which time representatives from each of those three agencies would be given the opportunity to spend the entire day with us as we have with this panel.

I think it is best for the Members of the subcommittee, in light of the fact we do expect to be interrupted by votes in the near term, it would probably mean that your testimony would receive full attention. And so I appreciate your courtesy in allowing us to do that.

Ms. WATERS. Mr. Chairman.

Chairman BAKER. Yes, Ms. Waters.

Ms. WATERS. Unanimous consent to enter into the record Congressman Fauntroy's testimony.

Chairman BAKER. Without objection, certainly.

Ms. WATERS. Thank you.

Mrs. JONES. Mr. Chairman.

Chairman BAKER. Yes.

Mrs. JONES. Before you make your closing comments, can I request of Mr. Skillern, Mr. Cunningham, Mr. Taylor. You have suggested in this record that you have information or, what is the word I want, policies that you would think would be appropriate for banking institutions and GSEs to use in determining whether a loan should be made or not. I would like to have you send that

information. Maybe other Members of the subcommittee would like it as well, but I personally would like it, and I would invite you to stop by my office and talk to me sometime. I am really a nice woman, OK?

Thank you very much. Mr. Nader, I am sorry, you, too.

[Laughter.]

Chairman BAKER. I would simply say in conclusion, the purpose of this hearing was an attempt to get consumer advocates, those involved in community redevelopment, to give us their perspectives with regard to the provisions of H.R. 3703 and any other suggestions you might think appropriate for this Committee to consider.

As I have said repeatedly and often, both Fannie Mae and Freddie Mac are well managed. They are well capitalized. There is no doubt they are highly profitable.

This hearing and series of hearings is not about criticism of any existing management decision nor any officer of either of those enterprises, but to recognize that we as Members of Congress do have an obligation to ensure that in the unwarranted, hope-never-to-occur event when they face financial difficulty that we have taken all appropriate action to protect taxpayers from unwarranted loss. That was a goal.

Second, in the course of these hearings, I think it has been clearly established, for me at least, that the enterprises could do an exceptionally better job of providing resources to consumers for which they were chartered and directed to serve.

I do not think there is any dispute that they have done a reasonably good job, but they certainly can do better.

I have come to the conclusion that those two goals are not mutually exclusive. We can have safe and well-run enterprises, properly regulated, that meet the mission statement as required by their charter.

And to the end that we can accomplish that goal by additional discussions and hearings, as long as I am able, I intend to proceed on that course.

I will suggest, Mr. Kanjorski, that if we have the study group and we rent the Kennedy Center, that probably would be required just to get the lobbyists in from the two GSEs much less Fannie Watch.

[Laughter.]

Chairman BAKER. There is extraordinary interest in this. And I fully intend to be cooperative and facilitate that meeting in any way we can, but I would suggest that we not have a meeting. That if we are going to do it, just like we are doing the hearings, we could complement our hearings and have a series of them.

And if Members evidence their interest in participating, I am certainly not going to avoid that. I would welcome it. Because I am of the opinion, the more you learn, the more you are going to find that H.R. 3703 is not off the range of responsible conduct for the Congress to consider.

Ms. WATERS. Will the gentleman yield?

Chairman BAKER. Certainly.

Ms. WATERS. Mr. Baker, I do not mind how ever you approach this, but we need good, solid information. It is very difficult for me to talk about the benefits of the GSEs and the subsidies without talking about the benefits and the subsidies that the banks receive and to measure them and to look at them.

I mean, we are sitting here, you know, guaranteeing that we will bail out the banks. We do not guarantee any bailout for the GSEs.

Chairman BAKER. Oh, I think we do.

Ms. WATERS. It is implied. And if people think that, that is one thing. But we guarantee that we are going to protect the banks, and we have these mortgage companies that run amok, who are not regulated, who in fact make the most unconscionable oftentimes loans with interest rates that I mean are just unimaginable.

So if we are going to do some comparisons and some measurement, let us have all of the information before us.

Chairman BAKER. I absolutely agree, and I am willing to do that in any forum that is productive.

All I am suggesting is that for the conduct of the hearings, we are pretty much constrained, as are all other committees of the Congress on any subject, to follow this format.

But in addition thereto, I think it would be helpful to have background available information from whoever chooses to participate. I welcome Mr. Kanjorski's suggested list of participants. And then we are going to have to figure out how we stitch it together and over what period of time we do this.

But ultimately, I am convinced more than ever after listening to this morning's panel that there is sufficient justification to take modest steps.

Ms. WATERS. Will the gentlemen yield one more time?

Chairman BAKER. No, I do not think this is—just one moment. I do not think this is the cure for cancer. I do not think every person who desires home ownership will get it tomorrow morning if we were to pass the bill, but I modestly say, I think it moves us in that direction. And failure to act I think would not be appropriate.

Ms. Waters.

Ms. WATERS. And again, Mr. Chairman, in considering everything that needs to be considered to make sure that we are doing everything we can for our consumers and our would-be homeowners, if this panel has that much validity and you appreciate them so much, then let's expand the role of CRA so that they can indeed do the kind of monitoring that is so very necessary to make sure that both GSEs and the banks and the mortgage companies and everybody are working better.

And I am going to tell you something. You said something earlier about I would be surprised that you would be willing to modify. You would be surprised. I would be willing to modify mine, too, if you join with me in support of CRA.

Chairman BAKER. Well, I think if we could get the GSEs up to what the banks do, we might have a deal.

Mr. TAYLOR. Mr. Chairman, just a point of information.

Chairman BAKER. Yes.

Mr. TAYLOR. There is a bill, the CRA Modernization bill, that has been signed onto by 25 Members of Congress. Your name on that

bill would go a long way toward I think what Ms. Waters would——

[Laughter.]

Chairman BAKER. I am of the opinion that my name on anything goes a long way in the current environment.

Mr. TAYLOR. It does, sir.

[Laughter.]

Chairman BAKER. I will be happy to consider all approaches. As I have said to those who are concerned about safety and soundness, H.R. 3703 is not constructed permanently.

At least I have made a suggestion. Now you might not like it, but what I would like to hear are some suggestions in writing about how we make it better.

We can work together. Our goals are not mutually exclusive. There are benefits to both sides of the ledger if we do it right. But it is important that we do it.

If there are no further comments, I thank all of you for your tolerance. The meeting is recessed until Wednesday, 10:00 a.m., June 21st.

[Whereupon, at 1:40 p.m., Thursday, June 15, 2000, the hearing was recessed, to reconvene at 10:00 a.m., Wednesday, June 21, 2000.]

H.R. 3703—THE HOUSING FINANCE REGULATORY IMPROVEMENT ACT—PART 2

WEDNESDAY, JUNE 21, 2000

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES
AND GOVERNMENT SPONSORED ENTERPRISES,
COMMITTEE ON BANKING AND FINANCIAL SERVICES,
Washington, DC.

The subcommittee met, pursuant to call, at 10:00 a.m., in room 2128, Rayburn House Office Building, Hon. Richard H. Baker, [chairman of the subcommittee], presiding.

Present: Chairman Baker; Representatives Lucas, Manzullo, Ryan, Terry, Toomey, Roukema, Royce, Kanjorski, Bentsen, Waters, C. Maloney of New York, and Jones.

Chairman BAKER. Good morning. I wish to reconvene the hearing of the Capital Markets Subcommittee. For those not attending last week's hearing, it went on at length and we determined to recess the hearing so that the participants of that second panel could be given full attention with the hearing today.

Additionally, at the last hearing there was a request that former Member Congressman Walter Fauntroy be given an opportunity to be heard. We are glad that he was able to work out to participate in our second panel this morning.

We have also, on that second panel, extended opportunities to Reverend Graylan S. Hagler and Mr. Bruce Marks, who is CEO of Neighborhood Assistance Corporation. These are additions to our originally-posted agenda for the morning.

At this time I would like to recognize our first witness, who is speaking here today in his capacity as a representative of the Citizens Against Government Waste, Mr. Tom Schatz. Welcome, Mr. Schatz.

STATEMENT OF THOMAS A. SCHATZ, PRESIDENT, CITIZENS AGAINST GOVERNMENT WASTE

Mr. SCHATZ. Thank you very much, Mr. Chairman. Thank you also very much for convening this important series of public hearings on the Government-sponsored enterprises, and for taking such an even hand in allowing each side to be heard.

I am Tom Schatz, President of Citizens Against Government Waste, a nonpartisan, nonprofit organization, with more than one million members and supporters nationwide who are dedicated to eliminating waste, fraud and abuse in Government.

CAGW is part of the Homeowners Education Coalition, or HomeEC, which is comprised of taxpayer groups, including those

represented here today. This newly formed group is raising questions with our members and the media, Congress and the public about the Nation's GSEs and how their activities impact taxpayers.

Based on the reports just this past Monday about Freddie Mac's agreement with the risk capital standards being proposed by the Office of Federal Housing Enterprise Oversight and the possible plans to split the company into two parts, it is clear that the Chairman's bill and these hearings are already having an impact on the GSEs.

CAGW was created sixteen years ago, following the report of the Grace Commission. The Commission examined the operations of the Federal Government, including Government-sponsored enterprises. I request that the Commission's recommendations on those GSEs be entered into the record.

[The information can be found on page 302 in the appendix.]

Mr. SCHATZ. The Grace Commission recognized that the GSEs' agency status assures them access to credit at a preferential rate. The Commission concluded that the implication of Federal support ensured that, quote: "even without full faith and credit, the Government would rescue an agency in trouble."

The Grace Commission concluded that the special advantages enjoyed by Fannie Mae and Freddie Mac acted as, quote: "a powerful disincentive for well-capitalized private sector entities to compete in the mortgage market."

The Commission summed up why it is important for Congress to convene hearings such as these and continue oversight of the GSEs. "The Government does not control agency growth because it is private, but the agencies depend upon Federal sponsorship for their growth. This contradiction has extremely important consequences now and for the future."

Fannie Mae and Freddie Mac were endowed at their inception with a raft of special privileges, which have been discussed at these hearings previously. They don't have to register their securities with the Securities and Exchange Commission, which saved them $280 million last year. They are exempt from State and local taxes, worth $690 million last year.

The total subsidy, according to the Congressional Budget Office, was worth $6.5 billion in 1995. That study also determined that one-third of the subsidy was absorbed by Fannie and Freddie rather than going directly to benefit homeowners.

Fannie and Freddie don't have to meet the same capital requirements that are imposed on banks and thrifts. They can borrow money at lower rates and their high bond rating is due to their financial fundamentals, the implied Government support of the enterprises and the competitive advantages they enjoy as a result of their special status.

Another great advantage is that financial markets believe that Fannie and Freddie are simply too big to fail.

CBO also found in 1996 that 40 percent of the earnings of Fannie Mae and Freddie Mac could be traced to their Government-sponsored status, and the implied guarantee is reinforced by the $2.25 billion line of credit that each has at the Treasury Department.

Since the creation of the GSEs, times have certainly changed. Home ownership rates hover near 67 percent. Fannie's and

Freddie's success in helping millions of Americans achieve the quintessential American dream of owning their own home is laudable. The economy is strong and both companies enjoy double digit growth rates.

If that were the end of the story, we wouldn't be here today. But the GSEs' duty to shareholders requires that they maximize profits. There is also that duty to the taxpayers, and again these missions do come into conflict.

While these links to the Government obligate Congress and regulators to pay special attention to what the GSEs do and how they do it, Fannie and Freddie have characterized those who have made an issue of their activities as being anti-home ownership, and some of the Members of this subcommittee have characterized the recommendations to reform the GSEs as being based simply on a fight for market share within the banking industry.

Mr. Chairman, let me set this record straight. CAGW has spent the past sixteen years exposing waste, mismanagement and inefficiency in the Federal Government. It is not our intent to drive up costs for homeowners. We are not members of FM Watch. I couldn't tell you who belongs to FM Watch or when they were created.

Our interest in this issue precedes the creation of that organization by more than a decade and the presence in Congress of the vast majority of the Members of this subcommittee. Our intent is to simply improve and increase oversight of Fannie Mae and Freddie Mac. The Treasury Department, the General Accounting Office and the Congressional Budget Office all share our concerns, and Chairman Greenspan of the Federal Reserve system also expressed concern recently over the systemic risks associated with the GSEs.

The housing GSEs have become so ascendant in the financial markets that their activities have far-reaching effects throughout the entire national financial system and therefore into the pocketbooks of ordinary citizens. In January of this year, Fannie Mae announced it was positioned to issue its debt securities in unlimited quantities. By 2003, the GSEs combined will have more debt outstanding than Treasury debt held by the public.

At current growth rates, they will carry $3 trillion in debt by 2005.

It isn't just the amount of their debt that should raise questions at these hearings. The GSEs purpose is to provide liquidity in the mortgage market, purchase mortgages and bundle them into securities and resell them to private sector investors who then bear the risk. The focus should be on the nature of the debt they hold, the maturity of the mortgage market and the direction that Fannie and Freddie are taking in the future.

In particular, the proposed replacement of Treasury debt with Fannie and Freddie debt as a marketplace or benchmark deserves the utmost scrutiny.

Since 1993, Fannie and Freddie have begun to repurchase their own mortgage-backed securities and hold them in their portfolios. This has directly affected their double digit growth rates over the last few years.

Instead of dispersing risk into the private market, the GSEs are reconcentrating it in their own portfolios, which are implicitly

backed up by the taxpayers. The question should be asked how repurchasing mortgage-backed securities furthers the congressionally-chartered missions of Fannie Mae and Freddie Mac.

At the same time that Freddie Mac is considering a long-term proposal to break up the company into two entities, according to reports on Monday, Fannie Mae announced it has begun to purchase from banks zero down mortgages. This means lenders who are financing 100 percent of the purchase of a home are selling these mortgages to Fannie Mae. These mortgages are usually available to the most qualified buyers, raising more questions about the commitment to low- and moderate-income homeowners raised by the witnesses last week. Also these zero down mortgages are expanding when lenders are increasing the amount of debt a borrower may carry and still qualify for a home mortgage.

Clearly, the cost and risk of default of a zero down mortgage is greater than that of a mortgage that requires 20 percent down.

Mr. Chairman, you asked us about H.R. 3703, and we strongly favor the elimination of the GSEs' line of credit with the U.S. Treasury. We also concur with Treasury Under Secretary Gensler's concerns as to whether commercial banks ought to be permitted to hold in portfolio unlimited percentages of GSE debt.

During his recent testimony before this subcommittee, Fannie Mae's chairman repeated several times that the activities of Fannie Mae pose zero risk to Government and the taxpayers. But in the world of high finance, growth and a high rate of return are inextricably linked to risk.

In addition, Fannie Mae has been running ads about the financial stress tests they are required to undergo. The stress test was established as part of the 1992 legislation, but it will be at least another year before it is activated. While Freddie Mac recently agreed that this would be a good idea, Fannie Mae has consistently resisted submitting to the stress test.

Mr. Chairman, we would like to submit this ad along with a series of letters from Fannie Mae criticizing the stress test into the record.

[The information can be found on page 297 in the appendix.]

Mr. SCHATZ. With Fannie Mae and Freddie Mac, we have two quasi-governmental entities that claim agency status when it suits them and simultaneously claim to be private financial institutions when it suits them. As one long-time observer of financial markets has noted, with the creation of Fannie Mae and Freddie Mac we have succeeded in privatizing the profits and socializing the risks.

Now while the economy is strong is the best time to examine crucial questions regarding the nature of the Nation's Government-sponsored enterprises. On behalf of our one million members and supporters, we thank the subcommittee for the opportunity to speak today and I look forward to answering any questions. Thank you.

[The prepared statement of Thomas A. Schatz can be found on page 289 in the appendix.]

Chairman BAKER. Thank you, Mr. Schatz. Your testimony and all of the addenda which you cited will be made a part of the record.

Our next witness this morning is speaking in his capacity as a representative of the National Taxpayers Union, Mr. Peter Sepp.

Welcome, Mr. Sepp.

STATEMENT OF PETER J. SEPP, VICE PRESIDENT FOR COMMUNICATIONS, NATIONAL TAXPAYERS UNION

Mr. SEPP. Thank you. Mr. Chairman, on behalf of the 300,000 members of the National Taxpayers Union, I am deeply grateful for the opportunity to testify today, not as a financial market guru or a political insider, but as something of an amateur historian. In some small way, I hope I can convey that the issue of GSEs should transcend any political environment.

To take just a quick jog down memory lane here, my organization has been involved in GSE issues since the 1970's, when we compiled a taxpayers' liability index. We testified at one of the first major GSE hearings in 1989. We most recently sponsored a conference, Freddie Mac and Fannie Mae: Issues for Taxpayers.

So obviously this is an issue of long-standing importance to taxpayers and taxpayer organizations.

Over the years, there have been many, many proposed reforms for GSEs, but they all have one thing in common. They are well beyond the scope of H.R. 3703, to the regret of some and the approval of others.

The bill essentially aims to improve oversight activity so we don't have the kind of gaps that allowed the S&L crisis to slip through the cracks unnoticed and develop into something that made a taxpayer bailout one of the only options.

The GSEs themselves dismiss any analogy to a potential second S&L crisis as paranoid. Well, a useful document to help test this analogy is this, "Origins and Causes of the S&L Debacle: A Blueprint for Reform." It was prepared by the National Commission on Financial Institution Reform, Recovery and Enforcement. I will refer to it from now on as "the Commission" in order to save time and a whole lot of words.

I will begin by quoting one of the Commission's most important findings. Quote: "Fundamental condition necessary for collapse, Federal deposit insurance on accounts at institutions."

Now, in a totally unsubsidized environment, S&L consumers would have helped to act as self-regulators against institutions that invested in deposits and risky portfolios, but the Commission concluded that the Government created an oversubsidized environment in which, I quote: "depositors could benefit with no meaningful risk of financial loss."

Although not mandated to do so by law, Washington does effectively extend a kind of deposit insurance to housing GSEs.

Now the GSE officials tended to downplay this connection, but the Congressional Budget Office disagrees, and again I quote: "Short of placing an explicit guarantee on the securities of the housing GSEs, the law could hardly be more clear: the Government's financial interests in the safety of Fannie Mae and Freddie Mac ensure that their obligations are safe from the risk of default."

Socializing the risk behind their investments freed the S&Ls from many prudent business constraints and allowed the industry

to grow by a spectacular 56 percent over a three-year period in the 1980's; but, we all paid the price later.

These growth rates are being matched today by Fannie Mae through other riskier ventures, such as consumer credit, jumbo mortgages and derivatives.

Now to return to the Commission report, I quote: "Factors precipitating the macro-economic shock of unprecedented high interest rates adopted to combat soaring inflation."

Due to their regulatory charters and their habits of business, S&Ls tended to operate in a niche market of long-term mortgages. This situation changed when interest rates began to soar, in turn leading S&Ls to disastrous attempts to grow their way out of their problems by seeking more profitable and more volatile investments. But if a new interest rate crisis were to affect Fannie Mae adversely, history would be repeating itself, not just inflicting itself on a new victim.

Earlier this summer, Treasury Under Secretary Gensler reiterated the observation that in the 1980's Fannie Mae was, quote: "insolvent on a market-to-market basis."

Now today, housing GSEs resort, within limits, to diversifying their holdings or services. However, there are few worlds left to conquer within a literal reading of their charters. This has created a dilemma that Congress and GSEs will have to confront. Diversifying portfolios within their mission risks concentration of entire lending sectors. Diversifying them outside of their mission risks a sort of industrial policy that could reward entities who enjoy a substantial public subsidy over their private rivals.

To cite yet another Commission finding, I quote: "Factors intensifying and prolonging the collapse—a systematic breakdown in the political system."

According to the Commission, regulators were often blinded to the poor business practices of certain S&Ls due to the absence of an information structure that obscured the extent of the mounting losses and the degree to which the Federal deposit insurance program and the Treasury were exposed to loss.

Despite recent efforts to establish reporting and capital standards for the GSEs, transparency is still an elusive goal. GSEs can trade on the New York Stock Exchange, but are exempt from SEC Commission fees and reporting requirements that burden other companies. Nor are they required to disclose trading positions held by top level managers. Private banks and thrifts must maintain a level of total risk-based capital for on balance and off balance assets at 8 percent. Fannie Mae and Freddie Mac fall under just two core requirements, 2.5 percent for on sheet assets, .45 percent against off sheet assets. An impartial risk-based standard is only now being implemented.

GSE officials say they are in a far better position than most financial institutions in the private sector, but outside analysts seem unable to reconcile those claims.

Now to conclude, the Commission observed that, quote: "Congress transformed S&Ls into agents of national housing policy and that Government regulation sheltered S&Ls from competition, allowing the industry to be profitable and failures to be rare."

But beginning with the interest rate problems of the 1980's, policymakers were, quote: "Ill-prepared to deal with the crisis, the result being a large and unnecessary expense to taxpayers that has shaken the public confidence in financial institutions, Government, and the political process."

National Taxpayers Union contends that this need not occur with other congressionally-chartered instruments of national housing policy, the GSEs. Any diehard GSE privatizer in this room can probably support the increased transparency intended in H.R. 3703. Just the same, any true believer in the refederalization of GSEs in this room can applaud the regulatory accountability intended by H.R. 3703. In short, all anyone needs to be in order to admire at least part of this bill is concerned, concerned that taxpayers, lawmakers and GSE officials all participate in this process on an equal basis. And a little healthy respect for history helps, too.

Again, I thank you for your time and I will try to answer any questions you may have.

[The prepared statement of Peter J. Sepp can be found on page 324 in the appendix.]

Chairman BAKER. Thank you very much, Mr. Sepp. We appreciate your comments.

Our final witness on this panel represents the Competitive Enterprise Institute, Mr. Fred Smith. Welcome.

STATEMENT OF FRED L. SMITH JR., PRESIDENT, COMPETITIVE ENTERPRISE INSTITUTE

Mr. SMITH. Thank you, Mr. Chairman. My name is Fred Smith. I head the Competitive Enterprise Institute, a pro-market public interest group that has long been active in financial regulatory issues, the banking and S&L deposit insurance crisis of the 1980's, most notably.

I am pleased to testify here today on the moral hazard problems created by Freddie Mac and Fannie Mae. I think you all by now know that that term "moral hazard" means a tendency of bad incentives to create bad risk management policies; the Freddie Mac, Fannie Mae problem.

These firms may once have merited some special attention as infant industries, but they have clearly grown up now. It is time to put them out in the adult private market.

The continuance of these special privileges creates a serious hazard to the market, to taxpayers, to the economy and perhaps most of all to the poor, whose real needs, economic opportunity, is given lower priority by pushing middle and upper class housing mortgages to the front of the capital queue.

I would like to add some more remarks to my prepared testimony that you had last week, and I also would like to add three documents that I think would help the subcommittee make a consideration. The first is a recent publication by the American Enterprise Institute, which details the level of the risk that Fannie and Freddie are imposing on the American taxpayers, "Nationalizing Mortgage Risk," and "A Microeconomic Analysis of Fannie Mae and Freddie Mac," by Robert VanOrder, who is the senior economist of Freddie Mac. He makes a lukewarm endorsement of his agency.

[The information referred to can be found on page 354 in the appendix.]

Then to illustrate that actually one can talk about things without putting everyone to sleep, a recent *Wall Street Journal* editorial, "Fannie Mae's Problems," the Dear Abby one that some of you saw this week, which was a wonderful illustration that economics doesn't need to be quite so boring.

That also illustrates that the task before you of educating the American public to the need for reform is not an impossible task. It is something you can achieve.

[The information referred to can be found on page 411 in the appendix.]

Let me summarize my testimony. First, note that Fannie and Freddie are strange organizations, neither private sector fish nor political sector fowl. As a result, no one is quite clear how these entities should be evaluated or how they should be held accountable. They are largely immune from competitive market regulation. They are outside the market discipline, and yet they lack effective political scrutiny.

Mr. Nader last week made that point very well, basically arguing that what we see here is profit-side capitalism and a loss-side socialism. That asymmetry is dangerous and evades the whole system of checks and balances that is the basis of the American political and economic system.

You know, we fought a war once to oppose taxation without representation. Yet today, in this situation, we have seemingly endorsed subsidization without representation. Did we really mean to define GSEs as Government-subsidized enterprises?

The roots of this problem stem from Fannie's and Freddie's ability to obtain funds at rates far lower than any real market firm. Cheap money guarantees them high profits.

Now making a profit is normally a tough game, but if you are allowed to play with monopoly money and everyone else has to use the real thing you can buy up all the houses, all the hotels, from Baltic Avenue to Park Place, without passing go and, of course, without running the risk of going to jail. Monopoly money makes it easy to become a monopolist, and as these hearings have illustrated, Fannie and Freddie are well on their way to becoming the largest monopolist in history. They, of course, argue that this misses the point. They simply want everyone to realize the American dream. Good rhetoric, not good policy.

First, note that some of the housing subsidy is dissipated in higher housing costs, just as some of the subsidized student loans contributed to the rapid increase in college tuition. You are going to be doing some studies on this issue. I hope you ask that an estimate be made of the extent to which the Fannie-Freddie system is actually making affordable housing less affordable to the poorest of America.

Still, as the ads we have been seeing over and over again in the papers illustrate, they basically are out there to try to persuade us that they really are vital to housing in America. They do, after all, lower interest rates. Doesn't this make the American dream more affordable, at least for those not priced out of the housing market? Perhaps.

But there are other American dreams: Getting a job, starting your own business, having a better school for your kids, and those dreams also require capital.

Fannie and Freddie create no new capital. They simply move it around the political game board. For those pursuing other dreams, Fannie and Freddie isn't a dream; it's a nightmare. At least in the game of Monopoly you can buy something else besides real estate.

Fannie and Freddie claim their successes reflect skill. Perhaps. Certainly there are some smart people at these agencies. At the salaries they offer, there should be, but the successes of Fannie and Freddie have less to do with their smarts and a lot more to do with their subsidies.

Had they been purchasing livestock, race tracks, movie theaters, car dealerships, railroads or even aluminum siding, they would still have made money. Indeed, give anyone in this room the right to issue their own personalized Treasury bills and I predict that they too will become very wealthy in very short order.

Subsidies weaken the stability of the American financial system. That is what moral hazard is all about, and it is those unintended consequences of helping one American dream at the expense of all the other American dreams that should concern this subcommittee, this Congress.

These risks threaten to get worse. Last week's hearing illustrated that point. Groups taking more funds for lower income housing were critical of Freddie and Fannie. They sought more resources for lower income housing. In my view, that will do very little to help the poor. Luring families into nonaffordable debt does them no favor, as I suspect we are going to be hearing later on today. Nor would it do much to address the affordable housing issue directly.

That problem is far more linked to any growth initiatives and other Government policies.

Yet it will certainly increase the likelihood of a Fannie-Freddie default. Fannie and Freddie are being urged to increase their riskier lending without incurring any additional risk. There is not much chance of that happening in the real world, but as long as the taxpayer is forced to cover those risks I suspect that Fannie and Freddie will be rushing out to do exactly that.

What can we do about all of this? Not much if we are not willing to rein this agency in, and political regulation has a very poor track record. The real problem remains that in any political calculus, Fannie and Freddie are already too big to fail. Their stock is held in too large blocks by too many important groups. Today if a crisis were to occur, it is unlikely that anyone responsible would actually get a haircut. The sad reality is that a crisis would more likely end in Freddie and Fannie getting a perm.

Tinkering at the edges isn't likely to resolve this instability. Rather, we should take advantage of the current good times and the good management of these agencies to diffuse this time-bomb while we can. I recommend that you do endorse most of the provisions of H.R. 3703. Phase out the ability of other groups to hold Fannie and Freddie stock as Treasury bill equivalents in their visible line of credit. End their exemption from State and local taxes.

Incidentally, as a citizen of the District of Columbia, I suspect that former Representative Walter Fauntroy will be recommending that later on this morning also.

Eliminate the ability of these agencies to use taxpayer backed money to enter other sectors of the credit economy, increase their capital reserves, and create a liquidation plan that would plausibly avoid a bailout if and when the next economic crisis occurs.

Some subcommittee Members have suggested we proceed carefully, and I fully agree. But that does not mean delaying further action. The unintended consequences of past inaction are already very serious, and the growth projection of Fannie and Freddie suggest that there is much worse in store. Delay is always the easiest course in the short term. Recall the prayer of the youthful Saint Augustine, "0 God, make me chaste—but not yet."

Still even if you move expeditiously, I suspect it will not be enough. Fannie and Freddie have no real world existence. They exist as artifacts of the special privileges they possess. Masquerading as market entities, they are better viewed as costly and complex means of transferring capital around the political game board. This is not wise. If we want to nationalize our credit industry, let's do it honestly rather than under the guise of GSEs.

Thus, I have suggested in my written testimony that DOJ be urged to develop a divestiture or breakup plan for Fannie and Freddie. They should be converted from TBTF institutions—too big to fail institutions—into normal market entities. You know that Fannie Mae's Ms. Gorelick comes from Justice and they have got a good experience at breaking up firms now. Why don't they take that expertise and use it to good purpose by breaking Fannie and Freddie into firms that are reasonable size and actually might be able to bear the risk of failing if they keep operating as they already do.

Congressman, Mr. Baker, this can't be a pleasant hearing for you guys. You are finding out in these hearings that Fannie and Freddie have outlived their usefulness, have engaged in mission creep to a level never before seen in history, have weakened the private housing finance markets and now they reject reform, and they are not paper tigers. They have massive resources and seem willing to use them, without limits, for lobbying, propaganda, political contributions and attacking anyone, including yourselves, who dare to challenge their supremacy.

Moreover, most of the people are only going to see the ads in the paper. They are not going to be at these hearings.

Yet, America has survived to date because we are a representative Government. You were elected to represent the good of the American people, not the privileges of the powerful. You have some powerful allies in this, Alan Greenspan, some members in the Treasury, when they are allowed to speak. Moreover, you have a bully pulpit to educate the American people on this issue, and the *Wall Street Journal* editorial earlier this weak makes it clear that you can do it.

This isn't that complicated. Indeed, any high school civics class in America would laugh the Fannie-Freddie get-rich-quick scheme off the stage. These hearings begin the educational process for reform. I would like to commend you, Chairman Baker, and everyone

on this subcommittee for the willingness to diffuse this time-bomb. We at CEI look forward to working with you and proceed with the rest of this process. Thank you.

[The prepared statement of Fred L. Smith Jr. can be found on page 345 in the appendix.]

Chairman BAKER. Thank you very much, Mr. Smith.

Mr. Schatz, you raised an important issue I had not previously considered in other hearings that I think from here on in I should certainly follow, and let me explain myself. There are allegations by some that people have economic interest in this issue and that there are lobbying organizations that are being formed and created to affect public policy, primarily for the purpose of economic outcomes.

Given those concerns, let me ask each of the witnesses this morning, are you here in your capacity solely as a representative of your respective organization or have you received compensation from the organization known as FM Watch or any business enterprise, let's say within the last two years, well before Fannie Watch started; in a two-year clock? I am only asking not for disclosure of your donors, but in relation to this issue have any of your respective organizations received economic compensation to participate or represent anti-GSE sentiment?

Mr. Schatz.

Mr. SCHATZ. Mr. Chairman, our history in this goes back sixteen years. Certainly the members of the Grace Commission included interests from the banking industry, so we continually receive support. It is very possible that someone who made a contribution off of our membership list has some interest in this issue, but we actually created this coalition with groups that we work with on a consistent basis to fight waste, mismanagement and abuse in the Government, bringing a lot of other coalitions together. It was our concept to come up with this group here, and certainly if anybody wants to support what we are doing we are happy to accept that support from any side of the aisle.

Chairman BAKER. So that is a qualified no? You may have someone who is a donor, but——

Mr. SCHATZ. Yes, it is possible. We do receive a lot of contributions. I am not trying to avoid the question, but I would have to look at every single person that gave us a contribution over the last several years, because we do receive a lot of individual contributions.

Chairman BAKER. But you can clearly say that no one has given a contribution to the organization with the intent of imposing a particular philosophic view on this subject?

Mr. SCHATZ. No. This is our view. We are representing ourselves. We have worked, as I said, with these organizations on budget reform and tax reform, and having looked at the Grace Commission recommendations, it often surprises me that the things that were proposed sixteen years ago are still relevant, but this is Washington.

Chairman BAKER. I will eagerly admit that each of you in your respective capacities have been long-standing troublemakers. I am just trying to establish on this subject there is some degree of purity.

Mr. Sepp.

Mr. SEPP. Well, presuming that FM Watch hasn't mastered the art of time travel, no, I am not being paid to say this. My boss wasn't paid to say it, my goodness, twenty-one years ago.

Chairman BAKER. Mr. Smith.

Mr. SMITH. No. But I think, as Tom pointed out, we also don't take any Government subsidies. So we are not funded by Fannie and Freddie. We certainly haven't been approached by any private groups, but, I guess, if you guys want to do more to help rational discourse on this, funding would be useful.

Chairman BAKER. Maybe something to be considered later.

Mr. Sepp, I understand it was the Taxpayers Union that took the 1996 CBO methodology and took current data, as best possible available, and made a determination that the current day value of the subsidy to be at least a $10 billion figure, is that correct?

Mr. SEPP. Yes, that was an NTU Foundation issue brief that we projected forward; yes, that was published about a year or so ago.

Chairman BAKER. And was it the conclusion reached in updating the value of the subsidy that about one-third of that amount was perceived to flow through the shareholders?

Mr. SEPP. Approximately one-third, yes.

Chairman BAKER. Well, that is consistent with the CBO's work previously. I have had some complaints expressed about the efficacy of that methodology and, for the record, I have requested that the Federal Reserve assist the CBO in establishing a methodology that hopefully will be above question, and we now have pending a request for an update of the valuation of that subsidy for that purpose.

Would each of you choose to make brief comment, because I am—maybe I will just save it for the second round. I am just about out of time. My next question was going with concern of concentration of bank holdings of securities by the GSEs and the potential for significant concerns about the Federal deposit insurance system in relation to those holdings. But I am out of time and I want to try to stick to the clock as best I can.

Mr. Kanjorski.

Mr. KANJORSKI. Thank you, Mr. Baker.

I guess we have to respect the fact that you all are rabble-rousers. That is good, because sometimes you are rabble-rousers on issues we agree on, and sometimes you are rabble-rousers on issues we don't agree on. I think all three of you are supporting my effort, and Mr. Boehner's effort, to oppose H.R. 21 in order not to create a Federal reinsurance program and subject the American taxpayer to undue risk. In that regard, I compliment you.

The problem is, there is not any winner or loser on this issue. On both sides of the aisle of this committee and on both sides of the aisle of the Congress there is a recognition that these unusual organizations require periodic study, mission definition, and control.

It is interesting, however, that last night we had on the floor Mr. Hinchey's amendment to the VA-HUD appropriations bill asking for full funding for OFHEO. That amendment made the request of approximately an additional $5 million, and all funding for that regulator comes from Fannie Mae and Freddie Mac. OFHEO has

concluded that these additional funds are necessary if they are to properly enforce the new risk-based capital standards, and they have requested the Appropriations Committee to make those additional funds available.

From my standpoint, there is nothing more important than strong regulation. It helps us to see what is happening in advance, and to try to prevent improper activities from occurring so that the horse does not get out of the barn before we close the door.

We are going to have a vote on that additional funding for OFHEO this afternoon.

[The prepared statement of Hon. Paul Kanjorski can be found on page 277 in the appendix.]

Now, I have one simple question for you. If you were sitting in the Chamber, how would you vote on the issue of providing the funding requested by OFHEO? This increase does not cost the American taxpayers anything, but comes out of the regulated organizations themselves. Apparently, the Appropriations Committee and a good part of the other side of the aisle have argued against giving those additional funds to provide for better regulation. How would you vote on that issue?

Mr. SCHATZ. Mr. Kanjorski, we have long supported the concept of increasing oversight by the Government. We would certainly hope that the Congress would approve that amendment. We would also like to see more funds for Inspectors General and GAO and other people that do these studies.

So I have no problem with that amendment.

Mr. SMITH. I guess I would have some. I am from Louisiana so good government was one of the early casualties in my belief system, but I think that the idea that more money will help the regulators to do a better job, maybe. I guess if I were in your situation I might well vote for it also, but I think the real inclination is to realize that nothing works better than market-based regulation, which essentially means that if you trust the institution you are investing in you are far more likely to be an effective disciplining force than a regulator who only has his intellectual acumen to go on.

Fannie and Freddie can outbid the pallet pool and will get much smarter people to run circles around any Government regulator.

Mr. SEPP. I would be forced to cast a vote in favor as well. I think that if Congress is to impose regulatory opportunity costs on private banks and institutions, well, then those institutions, the GSEs, can absorb those costs as well.

Mr. KANJORSKI. The bill we are considering here is something that prospectively will come to order to either reform the mission or the structure of GSEs. Today, however, this full committee and the Congress on both sides of the aisle are going to have an opportunity to put the money where their mouth is. That way, if they really do fear S&L disasters in the future, then they can support maintaining a strong regulator out there with the capacity to properly regulate.

It would be somewhat of an interesting position that here before the subcommittee we will be arguing to clean up the act of Freddie Mac and Fannie Mae. This afternoon, however, some of the very Members that are proposing this long-term cleanup or what could

prospectively occur in the future are declining the immediate vote today. Today's vote will provide the money to the regulators to do the job that may give us the opportunity to save financial risk in these organizations. Is that correct?

Mr. SMITH. Mr. Kanjorski, I agree in part. Obviously the sentiment you are expressing, I think, though certainly odd, I believe members of this panel would agree, the risk is that in effect you anesthetize the force that is now being developed to reform these institutions in a real, more substantive way. There is always the risk that by putting a sterile fruit fly in a niche, you never really do anything useful there.

I agree with you, I might well vote for it today.

Mr. KANJORSKI. I am not suggesting this afternoon's vote for stronger regulators is going to cure the problems that you have argued today. But, how could anybody on this subcommittee or in the Congress on either side of the aisle say that we should not at least give the regulators what they are asking for to do a proper job of regulation?

Mr. SMITH. I am not in Congress. I would probably go along with you, Congressman.

Chairman BAKER. Thank you, Mr. Kanjorski.

For the record, I also support that effort very strongly.

Mr. Smith, just to respond to one brief observation you made, I was in the Louisiana legislature fifteen years, and upon arrival in Washington I can honestly say I have not seen anything from the White House to the Congress that has impressed me as much, so I just want to make a record of that.

Mr. SMITH. I did not want to tell you I believed in Santa Claus when I moved to Washington. I still have the same skepticism.

Chairman BAKER. I think we are looking at the world the same way.

Mr. Manzullo.

Mr. MANZULLO. I was in Baton Rouge about four weeks ago at the old State capitol, whereupon I saw a very prominent sign that said "Democracy is not in the voting, but in the counting."

Chairman BAKER. I would only add there was a bumper sticker not long ago that said, "Vote for the crook. It is important." So I have to put all of this in perspective.

Mr. MANZULLO. Mr. Baker, my father was born in Louisiana and migrated to Illinois. So we understand what is going on.

I appreciate having us reconvene. Mr. Schatz, I would like to address my remarks to you. I have been very much concerned over this so-called grass-roots effort of our office receiving 2,000 letters, telegrams, ostensibly on behalf of the constituents that I represent.

I looked at these. I thought there was something odiferous about them and instructed my staff to call people from all over the district on a sampling. Of the 29 phone calls that we made, 8 people had agreed to put their name on that telegram or petition, whatever it is called—I think they called it a telegram—16 people knew nothing about the petition or the letter; 13 people said no, they did not want anything sent in their behalf, but they were still sent; 2 people did not exist at that address, and in fact, Mr. Sweeney has two constituents who sent him a telegram. The problem is that they were dead.

This was Fannie Mae's grass-roots effort, and it bothers me, because these are the good names of the people I represent that were being misused commercially to try to influence my vote here as a Member of Congress.

I wanted to know what this cost Fannie Mae. I think it is important, because any time they spend money on efforts like this it is written off and they don't pay taxes on that portion of the money that would be attributable to these expenses.

They refused, said "This is proprietary; we can't give this to you." But I did get enough information, Mr. Schatz, based upon the total names available, 352,000; total completed calls, 160,000. I believe I have asked you, because Fannie Mae refuses to tell the American people how much it cost for this grass-roots effort, I have asked to see if you could come up with a figure on that.

Mr. SCHATZ. Mr. Manzullo, thank you for allowing me to come up with this estimate. I would estimate, based on the kinds of activities we have engaged in in the past in telemarketing and also talking to people in the industry, obviously anonymously, about what the issue was, that it was anywhere from $250,000 to $350,000, conservatively, for this effort. That would include getting the names, making the calls, sending out the 45,000 telegrams, sending out about 33,000 follow-ups to the individuals who sent the telegrams.

The question I really had was really the process by which this was done. These people never saw a piece of paper explaining this issue to them. They received a phone call saying "There is a bill out there that will affect the cost of home ownership. Would you like to sign a petition? We are calling on behalf of the Fannie Mae." That is the essence of the script that I have looked at, which you have provided to me.

It seems to me that the normal process is that someone gets a letter first explaining an issue that is this complex. Clearly it is complex. There is a lot of disagreement about what should be done. It is also extremely important. And the follow-up phone call is if you don't respond or if you want to follow up and encourage people to sign the petition, but the normal process is to provide a piece of paper first.

Mr. MANZULLO. At least it is in front of them.

When the people received the phone call, they were told it was on behalf of a Coalition for Home Ownership. I inquired of Fannie Mae as to if they are the only ones behind this, how one organization could be part of a coalition, and there was no response to that.

I am also concerned over the fact that this could be a violation of false advertisement under the FTC or could indeed be an actionable tort for invasion of privacy whenever a person's name is used without their authority for commercial purposes.

It just really bothers me that even before getting to the merits of Mr. Baker's bill that we have to go through this fight with Fannie Mae to have them square up and be totally honest with us.

To this date, they have not. I received a four-page letter from Mr. Raines that tries to explain all of these things, and all he can say in that letter is the fact that "I should have contacted you in advance to let you know these were coming. For that, you have my sincere apology; that I understand why you would be concerned if

some people you represent were not sent confirming letters. I apologize if this was the case."

It goes on to talk about the computers that were used, the people that were involved, and so forth, but most interesting is the fact that he said that "we cannot reveal proprietary information."

The proprietary information is the 2,000 letters that he sent to us. There certainly was no reticence to send to us, falsified and misleading, the proprietary information. So I had to use you to be able to make this estimation, because Fannie Mae simply has not been square with me.

Thank you.

Chairman BAKER. Thank you, Mr. Manzullo.

Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman. I am not going to say anything about Louisiana or all of that.

Chairman BAKER. Thank you.

Mr. BENTSEN. I think it all goes without saying.

Let me thank you again for having these hearings. I do want to quickly go back to the Hinchey amendment before I go into another line of questioning, because it is fascinating that at the time when this subcommittee, under the Chairman's leadership, is taking a very hard look at the GSEs and in particular we are all waiting with great anticipation the final rules from OFHEO, and we know that OFHEO is receiving numerous comments on their proposed regs and trying to go through that, and whether you support the Chairman's bill or some variation thereof or not at all, I think all of us want to at least get some handle on the law that Congress passed in 1992, that we would certainly want to provide them with ample resources.

So I am glad to hear what the members of the panel had to say.

I do want to ask Mr. Sepp, with at least some grain of seriousness you said that you would support that amendment. Is that right?

Mr. SEPP. Yes.

Mr. BENTSEN. Would it be fair to say then that the National Taxpayers Union would not score that as increased spending on the annual survey that you all like to do? Or are you authorized to make that commitment at this point in time?

Mr. SEPP. Well, that decision is actually made by three people in our office. My view would be that it is imposing a regulatory parity with private agencies and in that respect it could or it could not be scored. I can't imagine that it would be significantly scored among the 200 or so votes that we would include in our rating of Congress given the fact that a lot of votes in Congress occur over billions rather than millions of dollars.

Mr. BENTSEN. I see. In this debate, would the panel tell me, do you believe that Fannie Mae and Freddie Mac, which are both Government-created entities, congressional-created entities, some might argue monsters that we created, do you believe that they have achieved their initial mission as Congress set out to do?

Mr. SMITH. Congressman, I think that the—actually the article I appended to my testimony, the one by the Freddie Mac chief economist, more or less argues that the original purposes of these organizations have been achieved. They were, after all, created

when there was no ability to have a nationwide banking system or an S&L system. We had State regulations which balkanized the industry, and therefore they basically were there to achieve some of the deficiencies that other Government policies had made impossible.

Those are gone. The ability of S&Ls and other institutions to raise money by being able to raise interest rates is present today. So the original purposes are gone. The real question is, are we inventing new purposes? And I think the answer is we are, and I think those are dangerous, because they lead us into unchartered waters.

So, yes, I think they have done what they were supposed to do. Whether that was right or wrong, or there were other ways of achieving that, we ought to go ahead now and get these off the taxpayers' backs.

Mr. BENTSEN. Anyone else?

Mr. SCHATZ. Mr. Bentsen, I would also agree that if you look at the strict chartered mission, that that is the case. And when you are talking about going out to Home Depot and you are going out and doing home equity loans, that those kind of things require the kind of oversight and careful thought that you all are giving this now. Whether that is something they should or shouldn't do, somebody should be taking a look at what's going on. Again, you have this conflict that was identified sixteen years ago, and I guess even longer by some other groups, that you have a profit motive and you have a taxpayer-based or congressionally-based mission that seemed to be in conflict. So at some point they do separate.

In reading the article—if you give me one more second, in reading the article about what Freddie Mac is talking about in the papers Monday, they were going to keep the GSE strictly limited to mortgages, period, and the other types of investments that they would make would be totally separate and private. So there is a recognition that there is a separation of those two purposes.

Mr. SMITH. Also there was an example, an earlier example, the Interstate Commerce Commission was created, of course, much earlier in history to regulate transportation rates and at a certain point the leadership of that institution, along with a lot of other American interests, decided that it was time to abolish that agency and allow rates and transportation to be set by buyers and sellers.

I think that was a wise move, and it was done in part, because of the leadership of the ICC.

One could hope that Franklin Raines will begin to show that leadership in Fannie Mae.

Mr. BENTSEN. My time unfortunately has run out. I hope we will have a second round of questioning, because you didn't completely answer my question. I think, Mr. Smith, you started to.

But I think what—if I can infer from what you said, is that in terms of the Congress being able to leverage private capital markets for the creation of a secondary market system and a stable supply of mortgage credit at a somewhat stable rate, that leverage has worked.

I don't think anybody said that it hasn't worked. In fact, I think what I am hearing from those who are concerned is that maybe it

has worked too well, to the detriment of some others. That leads me to another line of questioning.

Mr. Chairman, I will wait until the next round of questioning. Thank you.

Chairman BAKER. Thank you, Mr. Bentsen.

Mr. Terry. Excuse me, I had one other piece of business. Mr. Manzullo had asked that his letter to Mr. Raines and Mr. Raines' response to his initial request be made a part of the record.

Without objection, it would be made a part of the record.

Thank you, Mr. Manzullo.

[The information can be found on page 279 in the appendix.]

Chairman BAKER. Mr. Terry.

Mr. TERRY. No questions.

Chairman BAKER. Mr. Toomey.

Mr. TOOMEY. Thank you, Mr. Chairman. I would like to thank our witnesses for testifying today.

A couple of lines of questioning that I would like to pursue. One is, if any one of you could help me with this issue of quantifying in sort of a pragmatic or meaningful way the risk of loss to the taxpayers. The reason I mention this is we can easily quantify the extent of Government-sponsored enterprise debt, guarantees of debt, outstanding obligations, but as we all know, those obligations are collateralized with quite a lot of collateral in the form of home mortgages.

Now, there is still a significant risk, but I am wondering if there has been any systematic effort to say under various scenarios what kind of actual loss could be expected to be incurred. And, therefore, rather than just looking at the total face value of outstanding debt, what is the actual risk that the taxpayers are potentially on the line for?

Any thoughts on that?

Mr. SMITH. It is hard. The article by the Freddie Mac one basically is a very honest article, I think, and I commend it to you. It basically says we understand there is a systemic risk here. We understand there is a moral hazard, and putting a precise number to it is very difficult.

The other piece I recommended, the EAI one, again looks at the total outstanding debt, discusses some of the moral hazard aspects and essentially suggests that it is large and growing and will grow particularly if we move outside of the traditional mortgage market. But, again, I don't think anyone is very comfortable with a precise number. It would be nice if we had that. I don't think we do.

That is what markets are really for, to try to have someone who has their money at stake, not taxpayer money at stake, to make that assessment for us.

Mr. SEPP. I would also recommend this report, "Origins and Causes of the S&L Debacle," as it discusses in detail the proportion of savings and loan institutions that experienced financial difficulties and the portion of the industry that eventually was subject to the taxpayer bailout.

I can't locate the fraction very quickly, but I believe it was something on the order of 30 percent. So if you infer from a $200 billion taxpayer bailout or so, you are talking about a potential of some

$600 billion in assets and $200 billion of which eventually became subject to repayment.

Mr. SMITH. It should be noted in that case, the S&Ls are a good example, I think it is good to bring that up, because the real disasters did not occur before the crisis. They occurred when the crisis was perpetuated, allowed to continue, because of the so-called forbearance period when it was politically difficult to close the doors of some of these poorly managed institutions.

We only have two of these big entities out there now and the political pressures to forebear in these cases would be massive, and since they are so dominant in these fields, moving from relatively stable to total instability could happen very, very quickly in today's electronic financial market.

Mr. SCHATZ. Let me say one thing as well, Congressman, and that is that the increase in risk goes along with the changes in the types of investments. For example, going from mortgages to derivatives to home equity lines and home improvement loans, other things that both Fannie Mae and Freddie Mac are looking at or are trying to get into, that adds to their risk. Again, it is hard to put a number on it. I think it would be useful if the subcommittee would take a look at that, because we are all interested in that answer.

Mr. TOOMEY. I think it is important to have some methodology for assessing that, because what we are doing with—I mean, in the big picture what we are saying is that we are making a conscious decision for taxpayers to take a risk, and a risk involves a cost. I mean, there is a value to that risk, as we see in the marketplace every day. When you take risks, you get rewarded for it.

The taxpayer is not being directly rewarded. The idea is that the reward comes in the form of lower mortgage rates, and we can measure that. We can measure the extent to which we have lower mortgage rates, but if we don't know the risks we are taking we don't know whether the taxpayer, our society in general, is getting an adequate return for this, which leads me to my next question. Mr. Raines testified before this subcommittee, and in separate conversations he has indicated to the subcommittee and to me personally that 100 percent of the benefit of the savings that is derived from the implicit backing of the taxpayer, 100 percent of that is passed on in the form of lower mortgage rates.

Now, that strikes me as extremely counterintuitive, especially given the prima facie evidence of the spectacular returns that Fannie Mae has earned in terms of returns on equity.

I believe from earlier comments, that you folks are estimating that it is actually anywhere from a third to a half goes to shareholders and not directly passed on in the form of lower mortgages. I am wondering what kind of methodology do you believe we ought to use to analyze that question and be able to quantify how much of this benefit is going to the people who own stock in Fannie Mae versus those who want to buy a home?

Chairman BAKER. And you can do that briefly.

Mr. SCHATZ. The Congressional Budget Office has done that and, of course, there is disagreement with how they have done it, but I haven't seen anything different that indicates that they are wrong other than Fannie and Freddie saying that they are wrong.

Of course, you could look at a lot of these other investments as other ways that if their profit increases they could pass it on to the shareholders as well. Just to get quickly to the State and local tax exemption, for example, if they paid State and local taxes they would simply be less profitable versus saying that they are going to increase mortgage rates. It is kind of the Washington Monument syndrome. When you threaten to close down the Government, the first thing they close is the Washington Monument, because that is the thing people see, and everybody gets all upset, but there are a lot of ways to do this that would increase the opportunities for homeowners and maybe not make them quite as profitable.

Mr. SMITH. The OMB has an office that tries to estimate the level of these risks on on-budget entities, and I would suggest you ask the OMB's office that tries to estimate for like GNMA to figure out how to do it for this one.

But remember, there is also another big cost. We lower the rates for sort of politically preferred housing, middle and upper class housing, but we increase the capital cost for small businesses and an array of other ones that are pushed down the queue.

There is no creation of capital by Fannie Mae and Freddie Mac. It is just moved around. Where you help, you also hurt. I think we ought to estimate those harms, as well as the benefits.

Mr. TOOMEY. Thank you, Mr. Chairman.

Chairman BAKER. We will come back around to a second round since we have a limited number of Members.

Mrs. Jones.

Mrs. JONES. Yes. Good morning.

Mr. Schatz, are you saying that Fannie Mae and Freddie Mac have outlived their usefulness? And I need short answers. We have five minutes and I am going to cross-examine. No long answers, please.

Mr. SCHATZ. I noticed that last week, Mrs. Jones.

Mrs. JONES. Good.

Mr. SCHATZ. Their purpose is still valid. The question is whether they are the appropriate vehicles to perform that purpose.

Mrs. JONES. If they are not, who should perform that purpose?

Mr. SCHATZ. We haven't had the opportunity to have the private sector get into those areas, because they have pretty much foreclosed anyone from entering that market.

Mrs. JONES. So you are saying—you suggest that the private sector should perform the mission of Fannie Mae and Freddie Mac?

Mr. SCHATZ. They could. They could try.

Mrs. JONES. They could?

Mr. SCHATZ. They could.

Mrs. JONES. And they would do—would they lower housing costs if the private sector did so?

Mr. SCHATZ. This is a little bit of an answer to Mr. Toomey. If you had an institution that was truly nonprofit and you passed on all of your subsidies to——

Mrs. JONES. No, don't give me that.

Mr. SCHATZ. Well, nonprofit——

Mrs. JONES. The question I asked is, could they lower housing costs?

Mr. SCHATZ. They could.

Mrs. JONES. How?

Mr. SCHATZ. If there was a goal of an organization to provide the lowest possible mortgage rates at the least possible profit, they could do it.

Mrs. JONES. Now, are you suggesting that Fannie Mae or Freddie Mac are poorly managed?

Mr. SCHATZ. No. We are saying that they are managed in conflict with two missions, one of which is to produce profit; the other of which is to provide better mortgage liquidity.

Mrs. JONES. Do you find that that happens in other organizations as well?

Mr. SCHATZ. Sure, it does.

Mrs. JONES. OK. Now let me go to who would—currently, Fannie Mae does not make any mortgages itself, correct? The mortgage is made by the banking institutions, correct?

Mr. SCHATZ. Correct.

Mrs. JONES. OK. The banking institutions are saying that Fannie Mae doesn't buy all of the mortgages that we make and we think that is unfair; that is part of this whole discussion about reorganizing the GSEs, correct?

Mr. SCHATZ. Correct.

Mrs. JONES. What do you believe Fannie Mae should do differently in order to respond to the banking institutions' claim that they are not buying the mortgages that sit on their shelves and are causing dollars to be stuck in these large companies? Do you understand my question?

Mr. SCHATZ. Yes. It works both ways, because if Fannie Mae doesn't buy the mortgage it usually doesn't get made. They essentially determine what mortgages are created by the banks.

Mrs. JONES. It doesn't get made by the banking institutions?

Mr. SCHATZ. Right.

Mrs. JONES. It doesn't get made by the prime?

Mr. SCHATZ. Right.

Mrs. JONES. Because the subprimes are out there making the mortgages that the prime banks won't make, correct?

Mr. SCHATZ. That is correct.

Mrs. JONES. Maybe I want to move on. How much time do I have left, two minutes?

Chairman BAKER. Two minutes.

Mrs. JONES. OK. Let me talk with Mr. Sepp for a minute. What is the position of the National Taxpayers Union on the issue I just raised with Mr. Schatz? Should a private entity perform the services that Fannie Mae is currently providing?

Mr. SEPP. Yes.

Mrs. JONES. And how would that private entity—how would you improve home ownership rates if a private entity were in that position?

Mr. SEPP. Through the competitive advantages of the marketplace.

Mrs. JONES. Be a little more specific with me. Don't be so cute, OK?

Mr. SEPP. When firms compete with each other for business in an unfettered environment, they tend to deliver the best possible product at the lowest possible price.

Mrs. JONES. You are suggesting that Fannie Mae operates in an unfettered environment? Or a fettered environment?

Mr. SEPP. Yes.

Mrs. JONES. What is the fettered environment?

Mr. SEPP. The fettered environment is an unsecured profit margin that socializes the risks of their investments to taxpayers.

Mrs. JONES. Isn't it a fact that many of the banking institutions have socialized—what is the term you used?

Mr. SEPP. Yes, and that was a great contributor to the banking crises earlier. Fortunately, Congress helped to address that by establishing capital standards.

Mrs. JONES. Are you suggesting that the current banking institutions also find themselves in that position?

Mr. SEPP. Not to the degree that Fannie Mae and Freddie Mac do.

Mrs. JONES. Not to the degree. The question is, do they find themselves in that position?

Mr. SEPP. In a similar position.

Mrs. JONES. Thank you.

Lastly, Mr. Smith, in your commentary—there is not enough time here. I have a lot of questions.

Chairman BAKER. If you wish to get organized, there is a few number of Members and we are going to come back for a second round.

Mrs. JONES. I am going to use my last minute up, because I may have to leave in a moment.

This is Mr. Smith's testimony here. Mr. Smith, you suggest that H.R. 3703 is the means by which we ought to deal with the GSE dilemma, for lack of a better term; is that correct?

Mr. SMITH. I actually went beyond that and suggested we move to full privatization and provided a way of doing that.

Mrs. JONES. What would be the advantage to the homeowner for full privatization?

Mr. SMITH. Well, the homeowner is also a small businessman, and other factors. It would have a more rational capital market in the——

Mrs. JONES. Slow down, again. The homeowner is what?

Mr. SMITH. The homeowner also is either an employer or an employee. They also have schools to go to. They have other capital needs, and they would have a more rational allocation of capital for all of their dreams, not just the dream we pick.

Mrs. JONES. Wait a minute. Slow down. Most homeowners are not small businesspeople.

Mr. SMITH. Most homeowners are employed by someone who is either a small businessman or large businessman, both of whom have capital needs. Many of them have children that need to go to schools, and those schools need capital. City and State governments need capital. Everything that we have a dream about has a capital component, and we are distorting capital markets by this unfortunate entity.

Mrs. JONES. What is the distortion?

Mr. SMITH. The distortion is we are giving them special privileges that allow them to put middle and upper class housing above

the needs of the poor, above the needs of the employees in America, above the needs of the other American dreams.

Mrs. JONES. You are suggesting that Fannie Mae and Freddie Mac don't have the interests of low-income at heart?

Mr. SMITH. Of course, they don't. They are not even trying to provide housing in that area, because they can make more money by going after the low-risk loans.

Mrs. JONES. You say this is happening across the country?

Mr. SMITH. Well, they are the ones who have the markets for these loans, yes.

Mrs. JONES. And upon what statistics do you base this?

Mr. SMITH. The fact that they are not in the market for the so-called low-income marketing house. You have to be much more——

Mrs. JONES. Wait a minute. I am asking the questions. I want short answers.

Mr. SMITH. OK.

Mrs. JONES. Upon what statistics do you base the statement that you make?

Mr. SMITH. The data that shows where they are making loans and are not making loans. They are not in the so-called subprime market very heavily today.

Mrs. JONES. Whose data is this?

Mr. SMITH. Well, this is from all the stuff—well, it is in there. It is in the——

Mrs. JONES. I don't know what this is. For the record, what are you pointing at? For the record, tell me what that is.

Mr. SMITH. I am sorry. It is the Nationalizing Mortgage Risks: The Growth of Fannie Mae and Freddie Mac. It is a publication by the American Enterprise Studies of Financial Market Deregulation by Peter J. Wallace. It has a tremendous number of tables of where Fannie and Freddie are.

Mrs. JONES. Did you bring those for us?

Mr. SMITH. I have asked that they be made a part of the record.

Chairman BAKER. They have been made a part of the record.

Mrs. JONES. Thank you.

Chairman BAKER. If I may, Mrs. Jones.

Mrs. JONES. I said thank you. I am done.

Chairman BAKER. OK. Great.

Mr. Ryan.

Mr. RYAN. Thanks for coming today, guys. I wanted to focus on one narrow aspect of the whole GSE issue, and that is the repurchasing of mortgage-backed securities.

Mr. Schatz, I was able to hear your opening statement and you talked about the repurchasing of mortgage-backed securities. I don't think the people at Fannie Mae and Freddie Mac are bad people. I just think there is a conflicting mission, two missions, a shareholder mission and a Government mission. So it is the structure of the entities that is giving the conflict that is cause for these hearings. It is not bad motives, bad people. It is just a strange structure that tears them in two different directions.

On the mortgage-backed securities, I am still trying to find out how repurchasing 30 percent of your mortgage-backed securities is critical to fulfilling the mission of home ownership and securitizing the secondary market, number one. Number two, it poses a new

kind of risk on the books. It poses an interest rate risk, a prepayment risk on the book of business.

What I would like each of you three to identify and discuss is, as you analyze this, as you analyze the safety and soundness and the risk that is posed, does moving from 4 percent of repurchasing or retaining your mortgage-backed securities in 1993 to 30 percent repurchasing and retaining of your mortgage-backed securities, respectively for Freddie and Fannie today, pose a new kind of risk regardless of the kinds of hedging devices that may be available in the marketplace and is that mission critical? Does that do something to put people into more homes, or is that more of a profit motivated action by the GSEs?

I will start with you, Tom, and go through.

Mr. SCHATZ. Thank you, Mr. Ryan. Clearly, if you look at the structure of the GSEs and their original mission, it was to buy the mortgages, not mortgage-backed securities. So we talked briefly with Mr. Bentsen and others about the purpose and whether they have exceeded or outlived their purpose. That is related to providing an increase in profit, not all of which, of course, has gone back to homeowners; it has gone to shareholders. So this is a question the subcommittee should be discussing and I am certainly pleased you have brought it up, but I don't know how it is directly related to the mission.

Mr. SEPP. I am certainly at a loss as to its direct relationship to the mission. I would also say that that sort of risky practice, along with derivatives and the like, may be perfectly acceptable in a private lending firm or any other financial management firm, but when there is an implicit, full taxpayer guarantee, we need to look more carefully at that.

Mr. SMITH. Essentially, Fannie and Freddie were created to create a securitization market, a secondary market. They did that because other Government policies made it hard for a private entity to do that.

There is plenty of ability in the private sector to create secondary markets now. We don't need the Fannie and Freddie anymore. Why are they in this market? They are in this market because it allows them to make money. It is a product they can buy with cheap money and sell at real money rates.

It is not the mortgages that count. They could be buying anything. They could be buying McDonald's franchises and would be able to make money. If you can use cheap money and sell at real market rates, anything you buy you are going to make money on. It doesn't take brains; it only takes subsidies.

Mr. RYAN. Some people have compared this to the S&L crisis. I don't know if that is accurate or not, but I would like to go down this road a little bit further. By keeping these mortgage-backed securities in their portfolio, are the GSEs becoming more like the biggest S&Ls, doing asset liability management, than a mortgage conduit between originators and investors? Do you see a similar comparison, an interest rate risk? Do you see that, but on a much, much larger scale, because we are talking about trillions of dollars, not billions of dollars here? Do you think that that is an accurate comparison to make?

Mr. SEPP. I am afraid it is. I would pick up on Fred's point earlier that interest rates are such a volatile kind of economic indicator that you don't know that the liabilities are on the books, that the bailout is staring you in the face until it is too late. Having stopgaps in place, having transparency in place to catch this situation before it blows up in our face, that is the important thing.

Mr. SMITH. The reason that they are taking back these MBSs is, because when you are willing to assume risk you can make profits out of it. You get paid to take risks.

What they have done is they are getting the profits, but they are not taking the risk. That is the perversity in this situation. That is the obscenity of Fannie and Freddie.

Mr. RYAN. What the GSEs, and I don't want to put words in their mouth, I think what they will tell you and I think this is what Mr. Burns or Mr. Raines said last time we asked them this question, is that it ends up reducing interest rates, that the retaining or repurchasing of mortgage-backed securities reduces interest rates by a small number of basis points.

I find that when you look at the econometric miles that support that statement, it is not an analysis of just the retaining of mortgage-backed securities, but it is an analysis of the entire secondary market and the retention of mortgage-backed securities. So I wonder what the reduction in interest rates is attributed solely to reducing or retaining mortgage-backed securities? I think that is something that we ought to take a look at.

I see the time has run out. I yield.

Chairman BAKER. Thank you, Mr. Ryan. I intend on this next round to pursue further the mortgage-backed issue as well.

I think all Members on this side have been recognized once. Mr. Royce would be recognized, regular order.

Mr. ROYCE. I appreciate that, Mr. Chairman.

Another aspect of GSE expansion is what is happening with the Federal Home Loan Banks with the Chicago program. One of the things I wanted to look at, or ask the panel about, is with the new expanded powers from the Gramm-Leach-Bliley bill, are we concerned about what is happening with that Chicago program? I have a copy of a *Barron's* article entitled, "House Odds, Critics Say Home Loan Banks' Mortgage Program Puts System at Risk."

I thought I would just quote a couple of lines out of the article and then ask the panel for their observations.

One piece from the article says: "Chairman Bruce Morrison of the Federal Housing Finance Board, which oversees the Federal Home Loan banks, predicts that the volume of these loans will hit $100 billion in two years, because he is going to lift the cap." It says that "lifting the cap on MPF will be his last official act before Morrison quits June 30th."

The article goes on to say that "mortgage market worry-warts with whom we spoke"—that might be you gentlemen—it says that they "believe some of the banks are skimping on interest rate hedges on mortgage partnership finance loans to fatten their own bottom lines. Each bank decides how much risk it wants to take. Critics say the banks are leaving two-thirds of loans naked or unhedged on the assumption that they will all be paid off in five

to ten years. Such prepayments are common, owing to the propensity of homeowners to move or refinance.

"Another problem, say these worriers, lies in the bank's reporting. They don't mark their portfolios to market, because if a bank's loan portfolio pulls the institution under water, lenders might hear about it and pull out with their stock and thus leave Uncle Sam to clean up the mess.

"The system's own regulator," it goes on, "has proposed tougher risk-based capital standards for the Home Loan banks. Memories of the collapse of the federally-insured thrift system are apparently still fresh in Washington."

So let me ask about this particular type of GSE, as well and your observations on this Chicago program, if I could.

Mr. SCHATZ. I think, Mr. Royce, based on what you just said, clearly there are concerns about having these loans out there depending on people refinancing over a period of time. Obviously, if interest rates go up there won't be as much refinancing and we don't know what the Fed will do the next two times that they meet, but that will clearly reduce the number of people that will refinance, because the rates will be higher than they were just a year or two ago.

So I think clearly there is an increased risk. Again, greater regulation—I should say greater oversight is certainly helpful, and we appreciate you bringing that up.

Mr. ROYCE. Thank you, Mr. Schatz.

Mr. SEPP. I would have to agree. It is very easy to concentrate just on Fannie Mae and Freddie Mac and the matter of trillions of dollars of assets when there are other entities that have a smaller amount of assets but face very similar problems. I would think that what we should be aiming to do is to complete the job that Congress began and establishing meaningful capital standards for other institutions out there and apply them toward these institutions.

Mr. SMITH. The technical role played by these institutions can be played in a relatively risk-free way. You could totally hedge all of your risks, and so forth, but then you would also limit your profits dramatically.

What we are really seeing is a game playing where they get involved in activities that can have or cannot have risk, depending on how much you are willing to push that risk back to the private sector. They want it both ways. They want the profits, but they don't want the risk, and that is the problem with the Federal Home Loan Bank and all the other groups in this area.

Mr. ROYCE. I thank you, Mr. Smith.

In my view, the best policy would be to completely privatize all three of the housing GSEs, Fannie, Freddie and the Federal Home Loan Bank system, but by completely privatizing, I mean any tie to the Federal Government such as line of credit and any form of housing goals or mandates. I think we need to recognize that that is what this means if we go down this road.

Frankly, I think that should be the goal.

Mr. SMITH. Congressman, the *Wall Street Journal* editorial I mentioned earlier mentions that HUD itself is not very pleased with the performance of these institutions for the low-income hous-

ing goals and I think that is quite appropriate. These entities—when you get to the frontier of a financial—or any frontier, financial frontier or otherwise, you are dealing in a risky environment, an environment where a lot of creative energies are required. That is where you want all the safeguards to be in place, and nothing ensures better investment strategies than realizing that if I guess wrong it is my money, not your money that is at stake.

Mr. ROYCE. Thank you. I am going to, Mr. Chairman, for the record, if I could, insert this *Barron's* article.

Chairman BAKER. Without objection.

[The information can be found on page 287 in the appendix.]

Mr. SMITH. I read it too, Congressman.

Mrs. Maloney, did you have questions?

Mrs. MALONEY. Yes, Mr. Chairman. Thank you.

Welcome, everyone. It has been well established that there are many peripheral benefits of home ownership in addition to the financial investment that they represent to individual families. Homeowners are more active in their communities, they keep up their neighborhoods and work to prevent crime. They take a greater interest in their school districts and they really contribute more to the society, to their neighborhoods, their villages, their cities. When they own, they are really more responsible to their larger environment.

While I know these benefits may be hard to measure, surely all of you must agree that they have a very important value in our country.

I think that it is important to take these values or the values that home ownership brings into account when you consider the costs of home ownership incentives that the Government has enacted. These include the mortgage interest tax deduction, the Federal assistance programs and the benefits that go to Fannie Mae and Freddie Mac.

I would like to ask the panel to comment. Are you opposed simply to the benefits that Fannie and Freddie have or to all programs, Federal, local, State, even private sector, that operate to enhance or to advance home ownership? Do you acknowledge that there are important benefits to home ownership that Government should encourage?

Mr. SCHATZ. Well, first of all, Congresswoman, I appreciate your point and I don't want to be flippant, but I am curious to know if there is actually a list or an actual total of what the cost of those benefits would be. I don't know if the subcommittee has it or the full committee has it, but how they compare, for example, with other benefits the Government provides and what value we are getting.

Our point is to provide, if the Government decides affordable housing as a goal, the most effective way of doing that. It is not clear that Fannie Mae and Freddie Mac at least are the most effective way of providing that support right now.

We have FHA loans. You have other programs throughout the Government. You have a lot of other ways that provide people with assistance, but certainly the fact that the economy is going well and interest rates are relatively low is another way that provides people with the ability to purchase homes.

There are certainly a lot of benefits. Any neighborhood that has a lot of homeowners tends to be kind of a better maintained place, but I wouldn't want to insult renters by saying that either, because a lot of them are responsible as well. And not everybody should own a home. It is possible that people are somehow overreaching by these, for example, 100 percent mortgages that are being put out there as a product right now.

Mrs. MALONEY. But the FHA loans also that you mentioned, then we have many, many programs that encourage home ownership, but that also is Government, somewhat, supported.

So my question is, do you support FHA loans and say the tax deductions that we give to certain businesses that put up affordable housing, or are you just opposed to Fannie Mae? That is my question, is it just opposed to Fannie Mae or are you opposed to all Government-sponsored support?

Mr. SCHATZ. I didn't say we were opposed to Fannie Mae. I said that we were questioning whether they were the most effective way of providing support and how they fit in with all of these other programs. There were clearly concerns last week at the hearing about whether or not they are reaching to the subprime market, which I would assume would be of concern to a lot of people on the subcommittee.

We are looking for really an evaluation of how well those programs work. We don't think there is enough oversight, period, in Congress, and that is why we appreciate this effort right here.

Mrs. MALONEY. I appreciate Mr. Baker's leadership, too.

As I understand it, each of our witnesses on this panel supports the repeal of the statutory access of the GSEs to U.S. Treasury credit lines. Is that correct?

Mr. SCHATZ. Yes.

Mr. SMITH. Well, I certainly do.

Mr. SEPP. Yes.

Mrs. MALONEY. All of you do. OK. This credit line has never been used and would have a negligible impact in saving a GSE from large scale financial losses. As a result, would you explain why it would be important to repeal something that seems to be of little use and little more—it is really symbolic, it is obsolete, it has never been used? So I just would like to know why you feel so strongly about repealing that.

I apologize that I didn't get here earlier. We are having a debate on the floor right now that I had to participate in.

Mr. SEPP. Well, to use the S&L crises is just one analogy. After the Great Depression and throughout, say, the 1950's, 1960's and 1970's, bank bailouts and S&L bailouts were quite rare. The deposit insurance limit was raised from, I believe, $30,000 for $100,000 per insured account on the basis that——

Mr. SMITH. $5,000.

Mr. SEPP. Yes, from $5,000, on the basis that it would never be used; it would never certainly burden taxpayers to the tune of tens or hundreds of billions of dollars; but it did.

Mr. SMITH. The pipeline—as long as that pipeline is there, it is like it is very expandable. It is only $2 billion today. It could be $200 billion tomorrow, and that is exactly what we saw in the S&L crisis. By cutting the link and saying, look, you are out of the house

now, you are on your own, you finally make these institutions grow up. It is the only way to do it.

As long as they know that they have a line of credit to the parents, they are never going to be anything other than infant industries.

Chairman BAKER. Is that all, Mrs. Maloney?

Mrs. MALONEY. I just didn't hear from the first two panelists on my first question, and I apologize that I was not here to hear all of your testimonies, and I will read it tonight. But what is your goal? Is your goal just over—what are you trying to accomplish? He made clear that he would like more of an understanding of what the benefits are and a way to measure the benefits. I would like to know, is it your goal in this?

Mr. SMITH. Your question was a very good one. Obviously, I was the head of the Washington Cooperative Housing Association, co-ops in Washington, for a number of years. So I have a tremendous belief that ownership really does convey all of the things that you are talking about.

But, of course, there are many ways of achieving ownership. One is by having a healthier economy. One is to have more employment in the area, some of the things that were discussed at last week's hearing. To reach into that process and pull one variable out, mortgage rates, and not for all Americans, only for middle- and upper-income Americans, and therefore arguably raising the price for other people cut out of those mortgage rates, may not be a very effective way of conveying the benefits, which we all agree of home ownership.

I think one of the things that the subcommittee is looking at is possibly convening a study group or maybe convening a study which will look into these things a little bit better.

The argument is, is it better to have a healthier economy over all and then letting people use that for home ownership or whatever other dreams they have, or is it better to reach into that and to pull one privilege from one committee and another committee pulls another one and we pull the capital markets in too many ways and we make us all poorer than we would otherwise be and probably hold down home ownership?

Mr. SEPP. I would point out, of course, that the Tax Foundation, for example, shows that a median-income American family's single biggest expense is taxes. More so than housing, transportation or food. I would argue that that is an area we need to concentrate on if we are going to encourage home ownership.

Chairman BAKER. Thank you, gentlemen.

I would like to move on, if I may, Mrs. Maloney. We will come back for another round.

Mrs. Roukema, did you have questions?

Mrs. ROUKEMA. No.

Chairman BAKER. I just want to go briefly, because I would like to get to our next panel, I know Mr. Bentsen had some follow-ups, perhaps others, two very important issues raised so far, one with regard to the risk associated with holding one's own mortgage-backed securities. It is a phenomena that has grown rather dramatically over the most recent years. I may be just rhetorically

asking each of you to address this in writing at some subsequent point for the subcommittee's benefit.

As one prepares a new security instrument, if secured by the mortgages of thousands of homes, when you hold the whole loan in portfolio you have not only credit risk, interest rate risk, prepayment risk, all of the risks associated, that is probably the highest risk one could have, so you then form these new securities, pass them off to third party investors and the third party investor then assumes interest rate risk, decreasing the risk to the GSE itself.

So I am not a critic of mortgage-backed securities in themselves. I see the advantages they create in minimizing risk to the enterprises. However, when a third of one's portfolio is the repurchasing of your own mortgage-backed security, I would presume it is for income reasons, because there is a higher degree of risk; therefore, a higher rate of return is paid, and therefore enhances the profitability of the enterprises.

The sale of a mortgage-backed security does not create one new home loan for a consumer.

I would very much appreciate your professional staff taking a look at that issue and giving us a critique of those observations.

Second, with regard to concentration of bank holdings of GSE securities, there are in excess of 4,000 banks which hold 100 to 500 percent of capital in GSE securities. That does not mean all Fannie Mae or Freddie Mac, but it does mean GSE securities.

I would suggest that if it is any other GSE other than Fannie and Freddie, we ought to really be concerned. But to that end, loan limits to one borrower amount to 10 percent of capital not being made available to an individual, regardless if it is a AAA-rated corporation or not.

The advisability as to some transition rule perhaps charging the new regulator with responsibility to assess the risk, because if a GSE would stumble for any reason and market capitalization would deteriorate, the value of those holdings of those financial institutions—saying it another way, according to Gary Gensler, 41 percent of all institutions in the country have 100 percent of their capital invested in GSE securities, it is of enormous proportions in risk to the taxpayer if there were to be a downturn in the economy, a softening of home demand and interest rates tick up. Again, I know you didn't address it in detail in your testimony, but if you would make note and please give the subcommittee the benefit of your insight on that subject unless you just want to make a brief comment.

Mr. SMITH. I did mention in my remarks today, though, that we should move that capital out of other institutions. It is very dangerous for them to be holding so much of it, given the riskiness of these kinds of adventures. They are not Treasury bills. They shouldn't be treated as Treasury bills.

Chairman BAKER. Well, particularly since the only thing permissible for that purpose is Treasury's cash or GSE securities. I would suggest that a AAA-rated corporate bond may perhaps be an equally safe investment in relation to a GSE security.

Mr. SMITH. Well, people are looking at it who have their own money to risk rather than the regulators, I agree.

Chairman BAKER. Thank you very much.

Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman. Well, I would assume, just to follow up on that, that the CFO or the investment analyst at the bank that is making that investment, I would certainly hope they are looking at it, although I have dealt with a number of investment analysts over the years. Whenever anything goes wrong, they are always shocked to find out that they had not quite looked at something as closely as they should have.

Mr. SMITH. In preparation for this testimony, some people from the community called up and said, "Why are you against Freddie and Fannie?"

I said, "Well, I am not really. I just think they shouldn't be shifting risk." I said, "Well, let me ask you, would you be rating these groups differently and recommending you not be buying them so quickly if you didn't think there was a taxpayer line of credit and subsidy?"

He said, "Of course not."

I said, "Aha."

Mr. BENTSEN. Well, I think that—this is not my line of questioning, but I think we do need to keep in mind the fact—I think the Chairman raises a very interesting point. The reason why GSE debt is held is in part because it is considered eligible securities under the Bank Holding Company Act. So it has the same standard as community bonds and Governments and others.

I think it is a little bit of a stretch to infer that most banks look at this in the same way that they would Government debt. If they do, I think you might think twice about buying the stock of that bank.

Now, I want to talk a little bit about the secondary market actions. Are any of you all aware of any other type of financial institution engaged in the secondary market which buys back securities that it has packaged or offered for their own account?

Mr. SMITH. We could come back to that question, and I would submit the testimony. Of course, there are a lot of other secondary mortgages. There are accounts receivable. There are auto loans and other areas. So there are markets in those that exist. We can check and see whether or not those entities buy back or not.

Mr. BENTSEN. Anyone else?

Mr. SCHATZ. I don't know offhand of any, Mr. Bentsen.

Mr. SMITH. Of course it is different. They are bearing their risks directly, not through the taxpayers.

Mr. SEPP. I can't imagine that they would have such a high proportion.

Mr. BENTSEN. I will answer the question for you. I would think this is right, and I may stand to be corrected, but I think every market maker on Wall Street in every security buys back various securities that they offer, and the reason they buy them back is to enhance the secondary market for their securities and to enhance the primary market for their securities.

Now the question is, and I don't think anybody in the room knows the answer to this on either side of the table, and it is an intellectual question worth trying to get an answer to, is at what level are you buying your debt or offering on the secondary market for your own account to support the price to inure to the benefit

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of pricing at the primary level, or are you doing it as some form of an arbitrage play?

But I don't think you can say outright that this is some type of arbitrage play until you have had a chance to look at it, and I think that has been missed, with all due respect, by the panel as well as by Members of the subcommittee.

That takes us to a broader question. And so I think, Mr. Chairman, it might behoove us to perhaps bring in some market experts and economists who follow that type of activity to take a harder look at that.

The next question is this broader question, where I think people are going. That is, are the GSEs, by the benefit of their congressional creation and ability to borrow money at a somewhat subsidized rate, implicit or whatever, are they borrowing money cheaply and investing it with greater risk than they might otherwise, because they have the basically cheap money at their disposal so they just keep churning it to make more money?

Now, the panel has made reference to the S&L crisis and saying this is a potential S&L crisis occurring. It is correct, I believe, that the S&L crisis was initiated because of an interest in maturity mismatch given the type of products that S&Ls were created by. However, that problem, I think the panel would agree, and in fact you reference this in your testimony, was really exacerbated by actions by Congress that expanded the investment ability of the S&Ls into nonmortgage products, nonsingle family products, or nonmortgage products is probably better than single/multi, and basically led them away from their original mission where they were using somewhat subsidized money through the deposit insurance system and the question is, does that really compare to Fannie and Freddie where you also argue in your testimony that you are concerned that they are too heavily invested in mortgages and control too much of the market. Yes, if there is a significant downturn in the mortgage market across the country, which would mean there was something else going on in the general economy, then there would be a problem, but I don't think you can draw the—I think you have to be careful in drawing the same comparison.

It reminds me of my old English teacher saying you need to use the same tense in the same paragraph, and I am not sure you are doing that in your testimony. So I would recommend you do it.

I know the Chairman is about to cut me off.

Mr. SMITH. Could I respond briefly that? Because I don't think I agree with you there. I think that, first of all, it has been a while since I have looked at the S&L research literature, but I understand George Princeton looked at the extent to which S&Ls got into trouble who did and who did not use those expanded investment opportunities, and he found no correlation.

You can lose an awful lot of money in traditional mortgages, just like you can in all the other things they got into, and there was bad performance in both categories, but it didn't look like the use of those additional powers per se created it.

Having said that, let me argue that I think there is risk when you only have two guys as opposed to the thousands of S&Ls. One of those guys could have gone down, but it is impossible for me to

imagine Freddie and Fannie going down without a massive intervention effort. So the risk is very concentrated, it seems to me.

To allow them to go into the more risky markets, given the inherent risks they already take, I think does create a problem.

Diversification is good when it is your money. It is not good when it is our money.

Mr. BENTSEN. With the Chairman's indulgence, I want to say one thing. I do want to make a point. I think everybody, and I didn't get a chance to read all of Mr. Smith's testimony, but what everybody said was—and the question I have raised with every other panel—is, rather than follow the Chairman's approach of cutting Fannie and Freddie off at one end and shackling them on the other, wouldn't the appropriate approach be to say "you have finally grown up," using the analogy of children, "you have finally grown up and it is time for you to leave home and we are going to spin you off into the private market." Would that be the better way to go, and "we will not shackle you at all, you will become private."

Mr. SMITH. I would think that that would be an excellent recommendation. I think Fannie—you know, Franklin Raines seems to be a very competent individual. He certainly had a background of being able to handle high risk investment areas, and other leaders of other Government-sponsored enterprises, ICC, CAD, took the leadership and took their institutions private. I would love to see this leadership grow up and get out of the Government trough.

Mr. BENTSEN. I wonder if that is what FM Watch wants?

Mr. SMITH. I don't know what FM Watch wants.

Mr. SCHATZ. I have no idea what they want.

Mr. BENTSEN. I am not asking you really what they want.

Mr. SMITH. They may not, you know, because this could be a pretty vigorous competitor and they may like in between, not quite a fowl, not quite a fish. But that is—you are not representing FM Watch. We are not representing FM Watch. We are, I think, all trying to figure out what the best way is of representing the public interest in this category.

Mr. BENTSEN. Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Bentsen.

Mrs. Roukema.

Mrs. ROUKEMA. I do have a brief question. Well, it is a question, although I will qualify it by saying I was necessarily called away from some of the testimony or some of the questioning, so forgive me if this question has been asked in this way, but I do want to hear your answer to it and it somewhat relates to the first part of Mr. Bentsen's question. That is concerning the parallel with the S&L crisis. OK?

In the 1992 conference, new capital standards were established for Freddie and Fannie. Certainly I was here during the S&L crisis and one of those that led the reforms, but hearing what you had to say regarding the parallels there, it is my understanding that based on those capital requirement reforms of 1992, that OFHEO, the Office of Federal Housing Enterprises Oversight, claims that the capital requirements, $18 billion for both Freddie and Fannie, along with the ten-year stress test testing requirements, which my understanding is they enforce vigorously or rigorously, and that

very few banks or S&Ls could, even in this day and age, even now, meet the stress testing requirements which Freddie and Fannie are required to meet by OFHEO in that legislation.

So I agree that mission creep is a problem, and I think that is what Mr. Bentsen was referencing. So I agree with that.

But how do you respond in terms of those capital standards and the stress test requirement, and is that contradictory to what your observations were? Particularly Mr. Sepp, your reference to that study.

Mr. SEPP. Well, for my part the overt risk-based capital standards for on-balance and off-balance sheet assets for private banks and thrifts is 8 percent. Fannie Mae and Freddie Mac fall under just two core overt requirements, 2.5 percent on sheet, 0.45 percent off sheet. Now, this capital——

Mrs. ROUKEMA. Excuse me. So you are contradicting the numbers that I was using, that those capital requirements are not in place?

Mr. SEPP. To explain further.

Mrs. ROUKEMA. I see.

Mr. SEPP. The risk-based capital that Fannie Mae and Freddie Mac claim to be complying with and the stress test is based on, to my understanding, an internal model that they have developed that independent financial analysts have not really been able to analyze very deeply, and that is part of the problem. We have claims that risk-based capital standards are implemented and are being followed, but it has not been very easy for any of us here to verify that.

Mrs. ROUKEMA. So you are not disputing it. You are just saying it has not yet been verified that those standards are being maintained.

Yes?

Mr. SMITH. Let me take a different cut at that. One of my former employees is now one of the gurus in the derivatives market. He was a student of the late Merton Miller, who just recently passed away, who created the mathematics behind this, and from time to time I sit down and have a drink and he explains to me what all this market is about and how much risk is there and I walk away with a headache and not a lot more understanding.

There is an incredible array of very complicated, very sophisticated, risk management mechanisms out there. How they perform under various crisis situations is a very, very complicated process, and I think we have reached the point now in the financial markets, the mature financial markets in the United States and the world, where that disciplining task had better be done by people who have as much reason to get it right as the original investor does, and that is why generally CEI believes that the regulatory role will have to be performed by markets. They can't be performed by bureaucrats.

GS–14s are not going to be as smart as market analysts are going to be.

Mrs. ROUKEMA. All right. Thank you. We will have to go over these numbers again on this, but you did respond and we will check into it. Thank you.

Chairman BAKER. Thank you, Mrs. Roukema.

Mr. Kanjorski.

Mr. KANJORSKI. Yes. Would it be unreasonable for me to sum up your testimony? If you were testifying at the point in time when we were originally anticipating the creation of Fannie Mae and Freddie Mac, you would be opposed to the establishment of those organizations. Is that reasonable?

Mr. SCHATZ. I don't know, Mr. Kanjorski, if we would be opposed. I think we would probably look at how, number one, they were done at a time when we didn't have the benefit of the S&Ls and number two they were done at a time when there was a need to create this national mortgage market. The question would have been, and I would assume is debated, as to whether the private sector could have done that better than creating the something out of the Government, and if at some point—let me just say one more thing. If you had created them under these circumstances, at some point you would say they have achieved what they originally intended to achieve and at that point you want to move them into something else.

Mr. KANJORSKI. Mr. Sepp, would you have supported the concept of establishing these organizations?

Mr. SEPP. Well, hindsight being 20/20, it would be easy to say we would have opposed it from the outset. We probably would have recommended other alternatives to creating something that straddled both the public and private worlds.

Mr. KANJORSKI. OK.

Mr. Smith, what would you have done?

Mr. SMITH. I would have opposed it. I would have basically argued that you don't create a fix on a problem the Government has created in the first place.

Mr. KANJORSKI. Do you all believe that the secondary market for real estate would have occurred in the United States if we had not created those organizations?

Mr. SMITH. I certainly believe had we removed the barriers that prevented private actors from being in these areas, we would had a secondary market earlier, more vigorous and far more disciplined than the one we have today, yes.

Mr. KANJORSKI. Again, why do you think we did not have a small business secondary market until we created that?

Mr. SMITH. First of all, I don't know whether there are impediments there or not, but markets evolve. There are plenty of areas that we can envision markets going into that they are not there yet, and the best way to do it is to have people explore, create mechanisms, take risk, and that process has produced America. It is a great idea.

Mr. KANJORSKI. So, you probably would have been opposed to the creation of these organizations, but clearly you are telling us at this point they are fully matured and should be cut loose. If we cut them loose, having no input as to their operations or their mission, and with still only two organizations, do you think they are not going to be so large as to fail?

Mr. SMITH. That is why I have suggested very strongly that you do have—having created a Government-sponsored monopoly, you do have an instability problem. I would suggest you break them up

into subparts and then you have got a more stable privatization scheme. I think you have to think about that.

Mr. KANJORSKI. Well, we have other problems in the financial services industry. We have huge organizations that are, quote: "too large to fail." Would you agree?

Mr. SMITH. Because of deposit insurance, yes, we do.

Mr. KANJORSKI. OK. Do you think the Congress should move to break these organizations up?

Mr. SMITH. I think you ought to——

Mr. KANJORSKI. They are organizations, but if they fail, it is the general consensus that we are going to have to do something governmentally to bail them out. Is that correct?

Mr. SMITH. That is a question I would like to expand on later, but I think there are certainly situations where we bailed out institutions where I think subsequent analysis, like Continental and so on, suggested we didn't have to bail them out. I think very few of the S&Ls and private sector activities are too big to fail. I think none of them are.

I do think Freddie and Fannie, as artificial creations, have gotten way out of size and they are troublesome in the political environment we live in here.

Mr. KANJORSKI. Let us make the assumption that they are too large to fail and that we would have to bail them out. Would you still make the argument that it is better to allow them to do anything they wish, having no Government regulation or input as to their mission or their operations?

Mr. SMITH. No, that is not what I recommended. I recommended that you allow Miss Gorelick to use her talents to break them out and create viable institutions that can succeed or fail on their own, not on our wallets.

Mr. KANJORSKI. So, you are not breaking them in half, you are talking about breaking them in tenths?

Mr. SMITH. Well, that is obviously a question to be decided. But this isn't a complicated task. You take their loan portfolio, you randomize it and you give one fraction to each of the fractions you decide, and then those entities can fail and they should be allowed to. Let them decide how much risk and what lines of business they want to go into, but of course cut off all the other subsidies that we talked about earlier.

Mr. KANJORSKI. Mr. Smith, that is almost a fallacious argument. If we break them up into ten entities, and we have an economic crisis in the country, whether they are one entity or ten entities, they are all going to suffer loss. All ten would probably collapse.

Mr. SMITH. No, I don't think that is true. There is no reason why all ten entities have to have the same uniform policies. Absent Government subsidies, they would explore other strategies. Some would be high riskers, some of them would be low. Some of them would be better managed; some wouldn't be.

Companies don't succeed or fail as a whole. Why should a privatized Fannie-Freddie?

Mr. KANJORSKI. Did not our experience of the S&L industry really indicate that this issue is not a question of one failure to another?

Mr. SMITH. No, I don't think so at all, Congressman. We had in the S&L crisis a very large number of S&Ls. Many of them were well managed. The growth in the taxpayer burden, as I mentioned in my testimony, we went from a $600 billion asset industry to a $1.2 trillion. All of that growth, most of that growth, occurred in the below the waterline, the bankrupt entities, and it occurred because of the moral hazard that was created by deposit insurance. It did not occur as a market phenomenon.

Mr. KANJORSKI. Mr. Smith, that argument is always the argument that I hear from all my friends. This year's budget is larger than last year's budget. With inflation and the growth of population, that is inevitable. Our economy today, when this Administration took office, was a $6 trillion economy. Today it is almost a $10 trillion economy. Everything, proportionately, is that much larger.

Mr. SMITH. But that happened from 1981 to 1984 and the growth in the industry was not uniform. It occurred in the worst managed institutions, and some of the smartest investors in the world rushed to invest money in stupidly managed institutions, criminally managed institutions, because it wasn't their money at risk. It was our money at risk, and that is where the $200 billion bailout occurred because we left in place a moral hazard problem.

Let's diffuse the moral hazard of this entity before we face that crisis.

Mr. KANJORSKI. Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Ms. Kanjorski.

Mrs. Maloney, did you have another question?

Mrs. MALONEY. I know the Chairman wants to move on so I will be very, very brief.

Last night we had a debate over the funding for OFHEO, an increase. I would like to ask Mr. Smith, I understand that on March 9, at a press conference, the Competitive Enterprise Institute indicated that it found the idea of a single regulator, which is created under H.R. 3703, troubling. Is that still your view? And how do the rest of the panelists feel?

Mr. SMITH. Unfortunately, the person who was representing us has now left my organization, but, yes, we still have that position. But the position is a very subtle one. It is based on the view that the Federal Home Loan Bank element of this whole GSE complex is probably totally fulfilled, that it is a different entity and it could go in a different direction, and also a broad view that competing—if you are going to have regulatory agencies, competing bureaucracies, competing regulators, can sometimes create a more viable way of disciplining an organization than can a monolithic regulator.

Monolithic regulators with monopolies can sometimes too easily reach accommodation and nobody is watching the chicken coop. So it is a complicated position, but we do still have that position. We have reservations. We didn't take a position one way or the other in our testimony on that particular part of the bill.

Mrs. MALONEY. Would the other panelists like to comment?

Mr. SEPP. Having regulatory oversight in competing bureaucracies can be a good principle. I agree with Fred. But, of course, we are not really operating in an ideal world here and sometimes

when you fail to have sort of a coordination among overseers, the various economic problems of institutions slip through the cracks.

So what we need to do is explore the way to meld those two advantages together.

Mrs. MALONEY. Mr. Schatz.

Mr. SCHATZ. I think that the approach taken by Mr. Baker's bill is certainly a good starting point, and that the idea of one regulator would make some sense in this case, especially the way this one is constructed; that it is not subject, for example, to the appropriations process. You wouldn't be having the votes such as the one that is coming, I guess, sometime today about whether to add another $4.7 million to OFHEO. You would have it funded a lot differently outside of that process. It would be less political as well.

Mrs. MALONEY. OK. Thank you very much.

Chairman BAKER. Mrs. Jones.

Mrs. JONES. I want to try and be brief, Mr. Chairman, because I know everybody is ready to go, but I need to ask a couple more questions.

Mr. Sepp and Mr. Schatz, your organization endorses a flat tax. Is that correct?

Mr. SCHATZ. That is correct.

Mr. SEPP. Yes.

Mrs. JONES. How do you perceive them? Well, does a flat tax support home ownership? When you contemplate that, you would oppose, I am assuming, a home mortgage interest tax deduction and low-income tax credits?

Mr. SCHATZ. Ms. Jones, first of all, some of the studies of flat tax indicate that the average family would get about $3,000 more in income with which they could certainly make payments on a home.

Mrs. JONES. $3,000 doesn't do too much for owning a home, though, does it?

Mr. SCHATZ. If you look at an average mortgage payment or you look at other ways that people make decisions about what they purchase, then it would be certainly helpful.

I also, by the way, don't believe that if there were an actual flat tax, as we tried the last time in 1986, that you still wouldn't have a number of interests pushing for the home mortgage and charitable deductions. So we can talk about it as an ideal, but it is unlikely to actually occur.

Mrs. JONES. Mr. Sepp.

Mr. SEPP. I think the implicit deal of a flat tax was much like the 1986 tax reform. You get lower rates and fewer deductions. Now, obviously it would be up to Congress to ensure that the rates don't creep up again like they have since 1986, and erase the benefits that potential homeowners would have of more money in their pocket to buy houses on their own.

Mrs. JONES. So you are saying that because people would have more money in their pockets they wouldn't need a home mortgage tax deduction or a low-income housing credit to increase opportunities for affordable housing?

Mr. SEPP. Not necessarily, considering that one-fourth of all people who file an income tax return itemize, and yet 67 percent of people own homes. Obviously, not everyone who owns a home or wants to own a home has to take the deduction.

Mrs. JONES. But these are opportunities to encourage home ownership. That was the purpose they were put in place. Fair?

Mr. SEPP. Yes.

Mrs. JONES. Let me ask these questions, these T-shirts, "Stop Loan Sharking," what organization—are they with you guys?

Mr. SCHATZ. No, not us.

Mr. SMITH. I think they are the next panel, Congresswoman.

Mrs. JONES. OK. I didn't know. I saw them sitting there.

Let me ask this of you, Mr. Smith. What would the transition from Fannie Mae-Freddie Mac to total privatization look like? And over what period of time would that occur?

Mr. SMITH. How long does it take to grow up I guess is the question you are asking? How long does it take for anyone to grow up? I think those are good questions. I don't have the answers to those. I think that is part of what the study Commission should do, and you are looking at, as I understand it, as part of this bill as to how does one create a crisis management plan? I see it as breaking up or at least reviewing the potential breaking up of the entity into stable groups, cutting away the subsidies over a time period and then gradually releasing these into the real world to survive or fail. It could take as long as a decade. It is not so important how long it takes. It is very important that it start.

There is another approach, the one where Sallie Mae was privatized, which I know less about, but the idea of creating a sort of a secured current market and then allowing the high risk stuff to take place in a purely private enterprise.

Mrs. JONES. In the interim, how do you deal with market fluctuation? How do you keep that from occurring such that people are not penalized out there in the world, those who have no stock in Fannie Mae or Freddie Mac or any other institution, to maintain their ability to maintain their home mortgage?

Mr. SMITH. Well, market rates won't change that are out there now. They aren't going to change very much if we eliminate these subsidies. It is not a big market subsidy.

Mrs. JONES. The market rate changed just when we started having a discussion of a GSE. Surely it would change if you are talking about cutting them totally out. It did change, right?

Mr. SMITH. It did change, but remember, it changed for the middle- and upper-income. It didn't change for the people—it may have changed adversely for the poorer people in America who are not part of the subsidized housing market in that sense, they are under other programs, and very well may find themselves partially finding it harder to have affordable housing. When one group of capital users are privileged, other groups of capital users are deprivileged.

Mrs. JONES. I am done. Thank you. I would have liked to have had you answer it, but we don't have enough time. See you next time.

Chairman BAKER. Just for the record, from the date of introduction of H.R. 3703 through the date of the last hearing, using Freddie Mac's posting on the Internet of current mortgage rates available, mortgage rates during that period dropped 20 basis points. That is a matter of record.

Second, from June of last year through the current moment, Alan Greenspan has raised interest rates 1¾ points. I modestly suggest the Greenspan effect is of far more significance than the Baker effect.

Ms. Waters.

Ms. WATERS. Thank you very much.

Let me apologize for not being in the subcommittee earlier. We have competing committees and of course the floor that is going on with an important debate on the WTO. But I was anxious to try and get here, because I think that the amount of time that we are spending on this issue is unusual and almost extraordinary, as I look at how little time we spend on many issues in this subcommittee. But I must commend Mr. Baker. He is singularly focused on the GSEs.

May I ask you, Mr. Smith, and you may answer, too—I believe it is Mr. Schatz.

Mr. SCHATZ. Sepp and Schatz. You are close.

Ms. WATERS. I can't see without my glasses—whether or not you have taken any action—let me ask Mr. Smith whether or not you have taken any action to voice your concerns about Fannie Mae or Freddie Mac prior to Mr. Baker's getting involved in this issue?

Mr. SMITH. We have been involved in GSEs, it has been a general area—corporate welfare has been a theme of CEIs since——

Ms. WATERS. No, no, no. My question is very specific. Have you written or raised your voice or took leadership in any way to point out the ills of the GSEs?

Mr. SMITH. Generally, yes. I don't think——

Ms. WATERS. Specifically.

Mr. SMITH. I don't know specifically about Fannie Mae or Freddie Mac.

Ms. WATERS. OK. So this is the first time you have organized your thoughts about the——

Mr. SMITH. That is certainly true.

Ms. WATERS. ——about how bad GSEs are?

Mr. SMITH. Not GSEs. We have taken on that, but Fannie and Freddie——

Ms. WATERS. Fannie and Freddie, OK.

Mr. SMITH. The first in terms of Fannie and Freddie.

Ms. WATERS. Can I ask the other two gentlemen, because I don't know what your testimony was, and I am trying to go through it here, whether or not you have taken leadership, specific leadership, prior to now to write or to urge Members of Congress to take a closer look at Fannie and Freddie, because you felt that somehow they were involved in some actions that you did not think were good?

Mr. SEPP. Yes, we first testified on this topic before the Subcommittee on Oversight, Committee on Ways and Means, September 28, 1989. Our July August 1993 issue of our member——

Ms. WATERS. 1989, what did you testify?

Mr. SEPP. I am sorry?

Ms. WATERS. What was your testimony in 1989?

Mr. SEPP. Our testimony was in regards to the Fannie Mae and Freddie Mac.

Ms. WATERS. Specifically.

Mr. SEPP. Before the Subcommittee on Oversight, Committee on Ways and Means.

Ms. WATERS. Yes, but what I am asking is whether or not you were at that time pointing out the dangers of these GSEs.

Mr. SEPP. Oh, yes.

Ms. WATERS. And the fact that they had too much power, too much influence, and that somehow they should be reined in by Congress. Was that your testimony?

Mr. SEPP. Yes, indeed.

Ms. WATERS. Would you submit that for the record?

Mr. SEPP. Be happy to.

[The information can be found on page 333 in the appendix.]

Ms. WATERS. Anybody else take any leadership prior to now?

Mr. SCHATZ. Yes, Ms. Waters. This is the Grace Commission report from 1984. That includes several recommendations on the GSEs that I have submitted for the record, that the Chairman has included in the record, and I did mention that they pointed out the issues of the conflicting mission of the taxpayer subsidy and their private profit.

So this has been a sixteen-year discussion, not every year, but certainly on and off over the years.

Ms. WATERS. You have submitted that for the record?

Mr. SCHATZ. Yes, I have.

Mr. SEPP. So that we can take a look at that?

Mr. SEPP. I would also like to submit these other articles as well.

[The information can be found on page 341 in the appendix.]

Ms. WATERS. That would be fine.

Which of you are—how many of you are familiar with FM Watch?

Mr. SMITH. After these committees it would be hard not to.

Chairman BAKER. Ms. Waters, if I may help you on that point, before the witnesses began their testimony today, Mr. Schatz, in his testimony mentioned the fact that there are others out there trying to influence. And so I asked every panelist, every witness, had they accepted monetary compensation in the last two years from FM Watch or a related entity, had they been asked by any of those participants to construct this testimony, and I put all this on the record. So I just want the gentlewoman to know I asked those questions.

Ms. WATERS. I appreciate that, Mr. Chairman. Now let me just ask, you are familiar with FM Watch, and you are familiar with their strategy? Have you seen their documents, internal documents, about the strategy that they were going to employ in this subcommittee as it relates to Fannie and Freddie?

Mr. SCHATZ. No.

Mr. SMITH. No.

Mr. SCHATZ. As I said, we have all, as Mr. Sepp and Mr. Smith said, we have worked together on a lot of issues over the years on mismanagement, inefficiency and the failure to——

Ms. WATERS. No, no, no. I am just interested in now.

Mr. SCHATZ. But the answer is no.

Ms. WATERS. No. Are you aware of any of the strategy that has been put together by FM Watch?

Mr. SCHATZ. I have never met with FM Watch.

Ms. WATERS. I didn't ask if you have met with them.

Mr. SCHATZ. I may have read about it, but I can say that it was not the basis of my testimony.

Ms. WATERS. Are you familiar with the terminology of mission creep?

Mr. SCHATZ. I think that terminology has been used by others as well.

Ms. WATERS. But are you familiar with that as being a part of the strategy and the wording that has been used in the internal documents that describe how FM Watch was going to move forward in its efforts to rein in the GSEs?

Mr. SCHATZ. Only having read about it; not directly.

Ms. WATERS. All right. Let me just tell you why I raise these questions. You and I have some of the same goals for wanting to expand housing opportunities for poor people and for working Americans in this country. I think that we all must act in ways that will help to do that.

What I have been trying not to do is to get caught up in the market share war, the war of—that has been initiated by FM Watch, because they believe that Fannie Mae is expanding its mission, that the mission is creeping over into their area of subprime lending or predatory lending, however you want to define those terms, and what is interesting about it is the internal documents pretty much describe the manner in which they are going to move forward, and it appears that some are caught up in that strategy and some may be inadvertently caught up in that strategy using some of the same words, using some of the same terms, that have been described in the documents.

I would like to basically ask you, number one, if any of you believe that this is a battle between those who are organized under FM Watch, many of them bankers and mortgage companies, in order to stop Fannie Mae from encroaching on what they believe is their territory, or to slow them down, because they think they have gotten too big? Do any of you believe that?

Mr. SMITH. One of the—before you came in, Congresswoman, I introduced an article from an AEI report by the Freddie Mac senior economist. He actually argued that you can look at this market more as a market share battle, as you put it, between the traditional S&L institutions and Fannie and Freddie and actually saw it as kind of two Government entities fighting it out over their—using their relative subsidies, the fact that one has the power——

Ms. WATERS. Do you believe that there is a war, a competition war, that is going on now between FM and the GSEs?

Mr. SMITH. I think that Freddie and Fannie are certainly engaged in a war. You may have seen editorials in the paper that——

Ms. WATERS. So you think that the banks and the mortgage companies that are organized under FM Watch are not at all concerned about market share and have a strategy to put the brakes on them by way of creating public policy to do that?

Mr. SMITH. I think the argument that we have been trying to make, at least I have been trying to make as a panelist, is that the real challenge is whether or not we are harming affordable housing by the type of distortion to capital markets we are creating in GSEs. I think that is the more important question than whether

one entity or another—but if I had to pick I would much rather a private sector entity be in any market than a taxpayer-subsidized entity, because I don't think they manage our money very well.

Ms. WATERS. Mr. Smith, I appreciate that. I just wanted to know if you thought there was a market share war going on, yes or no?

Mr. SMITH. I think that Freddie and Fannie are engaged in the most predatory war I have ever seen in my life.

Ms. WATERS. No, I am asking do you think there is competition and a war going on between FM Watch and the GSEs?

Mr. SMITH. I have worked in now CEI, this is our seventeenth year. I have rarely seen any business entity fight for its self-interest as well as I have seen Freddie and Fannie fight for theirs. I would certainly hope FM Watch would be more effective in fighting for what it believed in.

Ms. WATERS. Thank you very much, Mr. Smith. Reclaiming my time, you refuse to answer that, so I take it that you would rather talk about what you perceive is a war between the GSEs rather than answer the question. Let me just ask——

Mr. SMITH. That was the——

Ms. WATERS. Let me ask any of the other panelists whether or not you believe that any of the entities that are organized under FM Watch are predatory lenders who are causing defaults of homes because of their lending practices where they have excessive fees, high interest rates and practices that are not in the best interest of the homeowners?

Mr. SCHATZ. Ms. Waters, if I knew who the members of FM Watch were—I am not trying to be flippant, but I don't know who.

Ms. WATERS. I cannot hear you.

Mr. SCHATZ. I don't know who belongs to FM Watch, so I couldn't answer the question. I honestly don't know who they are.

Ms. WATERS. I am sorry. You don't know who are members or who are organized under FM Watch?

Mr. SCHATZ. No.

Ms. WATERS. Do you think they are mortgage companies or banks?

Mr. SCHATZ. I don't know. You would have to look at them—I don't know who they might be——

Ms. WATERS. So you don't know the FM Watch—you don't know their relationship to these hearings and their strategy and how they play into all that we are doing?

Mr. SCHATZ. We represent a million members and supporters, as we have been looking at this since 1984, so I would in essence say, if there are arguments about the GSEs, maybe they took some of them from us, versus the other way around.

Mr. SMITH. You should invite FM Watch to talk about these issues.

Ms. WATERS. Excuse me. My time, Mr. Smith.

I think that is very interesting, and let me just say that you may want to look at some of the underlying influence on what you are here today to talk about, because I think it is very important for you to know and understand, particularly if you are interested in expanding the opportunities for people to be homeowners.

Thank you very much, Mr. Chairman.

Chairman BAKER. Yes, ma'am. Just for the record, to accommodate the lady's inquiry, I am making note that most Members had two rounds of questions and five minutes apiece, so I did let you go on for ten or twelve minutes. That is to equate your time with everyone else.

Ms. WATERS. Well, that means I have a little more time coming.

Chairman BAKER. No, you actually went over, two minutes beyond what anybody else got.

Ms. WATERS. All right. Then I will relinquish.

Chairman BAKER. Thank you very much.

Before we dismiss this panel, I want to express my appreciation to your courtesy in postponing and coming back a week later to give us your testimony. I would note for the balance in the record that each of you, in some form or fashion, felt H.R. 3703 had elements that were advisable, but none of you claimed, I don't think, that it went as far as necessary; that each of you had varying degrees of how one would get to privatization, which H.R. 3703 does not advance.

Am I correct in characterizing your testimony as H.R. 3703 is a modest beginning from your perspectives, is that correct?

Mr. SCHATZ. Yes.

Mr. SMITH. That is my perspective, Congressman.

Mr. SEPP. Yes.

Chairman BAKER. Well, I just wanted to point out for the record that as usual I am right in the middle of all of it.

Thank you very much for your testimony.

I would like to ask our second panel to come forward. We have Mr. Bruce Marks, the Chief Executive Officer of the Neighborhood Assistance Corporation of America; Reverend Graylan S. Hagler, Senior Minister of the Plymouth Congregational United Church of Christ; and former Member also of this committee as well, and DC. Delegate, former Congressman Walter Fauntroy, but who appears today in his capacity as representative of the National Black Leadership Roundtable.

If the witnesses would come forward, please, I welcome each of you to our hearing today.

I would first recognize Reverend Hagler for any comments you choose to make. Your official testimony will all be made a part of the record, and if you would choose to summarize your written testimony that certainly would be helpful. Thank you, Reverend

STATEMENT OF REV. GRAYLAN S. HAGLER, SENIOR MINISTER, PLYMOUTH CONGREGATIONAL UNITED CHURCH OF CHRIST, WASHINGTON, DC

Rev. HAGLER. Good afternoon. Thank you for the opportunity to be here. I am Senior Pastor of Plymouth Congressional United Church of Christ, located in the District of Columbia. I am also Development Director for the Neighborhood Assistance Corporation of America, which is a nonprofit organization that is represented by Bruce Marks here today, based out of Boston, Massachusetts.

I want to direct some of my comments clearly toward Fannie Mae and Freddie Mac, but my primary experiences have been with Fannie Mae. There is a frightening dimension of Fannie Mae, and I say this after witnessing its heavy-handed techniques in helping

to shape public opinion and even causing advocacy groups to acquiesce to the power and influences of this publicly traded Government-sponsored enterprise.

For the last two or so years, I have watched and participated as Fannie Mae and Freddie Mac have hosted numerous conferences and gatherings, which means that they have in part at least financially underwritten those gatherings and many of the conferees under the auspices of groups like the Civil Rights Leadership Conference, the National Community Reinvestment Coalition and the Neighborhood Reinvestment Corporation. I watched as Freddie and Fannie peddled their desire to engage in subprime lending, taking the position that some people would never qualify for prime lending, but still needed to be serviced and they were the ones who were able to attend to this underserved market.

At face value, one would not necessarily see the problem with an arrangement of this kind. After all, conferences should be an environment where ideas are allowed to flow, disagreements surface and strategies for addressing problems gel.

Unfortunately, I found that these conferences are usually not the place for this type of interaction or development. Instead, the purpose seems to be clear, particularly when they are underwritten by Freddie or Fannie, and that is to buy submissive loyalty with silent approval to the actions and the new ventures that these GSEs want to participate in.

An example of this occurred nearly three years ago. While participating in a conference on community lending by a nonprofit organization here in Washington, DC., which was partially underwritten by Fannie Mae, I with some colleagues challenged then CEO of Fannie Mae, Mr. Johnson, in reference to zero down lending. Approximately a week after challenging Mr. Johnson, I received a note from the executive director of the nonprofit organization saying Fannie Mae has canceled an $80,000 grant with us. Are you happy?

The note was in direct reference to the questioning that we subjected the CEO of Fannie Mae to around their position on zero down lending.

Another glaring example of Fannie Mae's ability to shape public opinion took place during the recent serious financial crisis in the District. I, along with many other clergy, engaged Fannie Mae and engaged the public, particularly around the issue of the tax exemption of Fannie Mae, and pressed Fannie Mae in hopes of recuperating some share of revenue that is protected from taxation for the District of Columbia. It only seemed fair, because roads and water and fire services and police services help to facilitate this profitmaking, shareholder-owned, Government-sponsored enterprise.

However, as we participated in the work, gradually one minister after another dropped out of the work of the coalition with each quietly meeting with me and citing that they had received money from Fannie Mae for one project or another, and therefore their speaking now or acting or organizing would no longer be prudent.

Though this advocacy didn't bring any new monies into the District, evidently for the price of silence and inactivity some groups

received funds that may not have otherwise been made available to them.

These two examples, I believe, are important ones, because corporations like Freddie and Fannie, which enjoy special benefits and subsidies by being GSEs, should not be engaged with the public in ways that quiet protests, mute questions or discourage spirited debate. However, the very size and money of these GSEs has leaned toward this tendency and when so much is spent on public relations like "Showing America the Way Home," there is a natural resolve to silence anything that threatens to tarnish the hype.

It is clear to me that these GSEs need more scrutiny and accountability. Being a type of hybrid, both a shareholder-owned corporation and yet enjoying generous Government subsidy, these GSEs sometimes get caught up in their own spin. On the one hand, they seek and claim to do good, making money available for home ownership and attempting to come up with strategies to help larger segments of the American population achieve that dream. Yet at the same time, these GSEs are responsible to shareholders in maximizing return on investment.

I believe this is one of the motives that have led Fannie Mae and Freddie to enter the subprime market. Of course, Fannie and Freddie publicly claim that they are entering those markets, by doing so they have the ability to regulate the dollars and the product in the arena and therefore, in a sense, clean it up.

However, the real reason can probably be more accurately found in higher interest rates, greater fees, prepayment prohibitions and greater profits to the corporation and the shareholders. A friend of mine once told me that "De-nial is more than a river in Egypt."

Of course, the real fear is that when the economy goes south or just through one of those cycles that we normally go through, if Fannie and Freddie are engaged in these subprime markets then they will be left holding the bag and the American taxpayer with them.

If Fannie and Freddie are protected by their great ability to buy silence, then who is going to protect Joe and Jane Taxpayer from the imprudent moves that come when one is above questions and fair criticism, like it seems that Freddie, and particularly Fannie, is?

It has been suggested by previous witnesses that these GSEs should be setting the standard for what is offered in the marketplace; they should not be spiraling the market downward and into exploitation and predatory lending, but should be leading the market upward to new places of social responsibility.

I concur with the previous witnesses that these GSEs should be monitored and evaluated according to a well-founded criteria of social responsibility, meaning: what communities have been helped by these enterprises; what families, precisely where; what income levels and how have these enterprises made a difference in the particularly under- and unserved communities?

Also as a final note, it is dangerous and frightening and undemocratic that GSEs like Fannie Mae, while receiving billions of dollars in Government subsidy, also uses millions of dollars to lobby Congress, fund political campaigns and silence critics. This is an unfair and unintended advantage of these GSEs and should be corrected.

It further protects the GSEs from scrutiny and even regulatory inquiry, because they have the right and financial might to politically lobby and silence any critic they choose.

Thank you.

[The prepared statement of Rev. Graylan S. Hagler can be found on page 413 in the appendix.]

Chairman BAKER. Thank you very much, Reverend.

Our next witness is the Chief Executive Officer of the Neighborhood Assistance Corporation of America, Mr. Bruce Marks. Welcome, Mr. Marks.

STATEMENT OF BRUCE MARKS, CEO, NEIGHBORHOOD ASSISTANCE CORPORATION OF AMERICA

Mr. MARKS. Thank you very much. It is good to be here.

Let me try to summarize my remarks and make them as brief as possible so we can answer any of the questions. I am the CEO, as you have stated, of the Neighborhood Assistance Corporation of America. We are the largest housing services organization in the country. We now have 21 offices around the country. We have $3.8 billion in the best mortgage product in the country for working people. Through NACA you can buy a home with no down payment, with no closing costs, no application fee, 7.5 percent interest rate. Sounds too good to be true, but it is the reality.

Some of the members are behind us in the yellow shirts. We have been in the forefront of taking on predatory lending. We had attended Senate Banking Committee hearings five years ago, focusing on Fleet Finance. Obviously the predatory lending hasn't stopped. The HOEPA legislation that was passed was only the first step.

When you deal with predatory lending, Mr. Chairman, you are absolutely correct, you have to focus on the GSEs. We can talk about this predatory lender or that predatory lender, and you look at them as roaches out there. You step on one; two or three of them are just going to be right out there doing the same thing, sometimes worse.

But how is it that the predatory lenders are able to survive? It is because you have got the GSEs, who are subsidized by the taxpayers out there, who have a mission to lend to low- and moderate-income people, but what they do is they are creating the market. They are preventing working people who are credit qualified, hard working people working two or three jobs, who should be able to get a conventional loan, but these working people cannot get conventional loans. This is because the GSEs define a conventional loan, which is often referred to as a Fannie Mae loan.

Fannie Mae sets the standard for a conventional loan. When Fannie Mae says to people that if you don't have considerable savings, or you don't have perfect credit, then you can't get a conventional loan, they create the market for subprime lending. So the only way to systematically reduce in a considerable way subprime lending is to expand the criteria for how working people can get a conventional loan. That means to hold Fannie and Freddie and the other GSEs accountable.

Let me give an example. Lawrence, Massachusetts, in 1994, was a city that was going through hard times. NACA decided, with

some private sector non-government entity lenders, to do lending in Lawrence, Massachusetts. Over the last five years, 600 people have purchased homes in Lawrence, Massachusetts through NACA and major lenders. They purchased a home with no down payment, no closing costs, and no application fee, at a below market rate. Now Lawrence, Massachusetts, is open for business. It is a stabilized, growing community.

Fannie Mae said they would not buy any mortgages in Lawrence, Massachusetts, or required a premium because it was, quote/unquote: "a declining value community." Fannie Mae and Freddy Mac redline communities. That is why the predatory lenders are able to survive and grow. If NACA did not do lending in Lawrence, you would have seen the predatory lenders out there just like they are throughout the country.

So it is extremely important that your focus is on the GSEs. It is a predatory lending issue. If the GSEs want to do whatever they want to do to maximize profits, let them, but don't let them do it on the backs of the taxpayers.

Let me talk about some of our experiences with Fannie Mae. Fannie Mae plays hardball. So some of the questions we have heard here were how does Fannie Mae try to get the support of the Congress and how do they organize to keep their tax exempt status?

One of my staff people got a call. The caller said that they are a nonprofit and they are calling for Fannie Mae, and they asked a question, "Are you for affordable housing?"

And the staff person said, "Yes, I am for affordable housing."

They said, "Well, do you know that Congressman Capuano is trying to destroy affordable housing because he is trying to take on Fannie Mae, he does not support Fannie Mae?"

"No, we didn't know that."

"Well, will you sign a letter that says that we support Fannie Mae?"

This is what they are doing. This is what they are doing with our tax dollars. And so we are here with NACA, with thousands of members around the country, in support of H.R. 3703.

Mr. Chairman, you are exactly right. They have to be held accountable. These are important hearings. It is important that there is an oversight committee that oversees the GSEs. It is important that they get the tax benefits taken away from them. We don't come here very often to testify, but we do organize around the country.

Working people out there are fed up with Fannie Mae saying that because you don't have substantial savings, you don't have perfect credit, or you don't meet our other standards, then you cannot be homeowners.

What we have here is we have thousands of postcards from thousands of people, real people, not people who have been scammed by Fannie Mae, who say, "I am a hardworking taxpayer who has always dreamed of owning a home. It is outrageous that a taxpayer-supported organization such as Fannie Mae believes that I am unworthy of home ownership because of the requirement that I save thousands of dollars to meet their qualifications." And it goes on.

These are the people with their names and their addresses, thousands of people from around the country, Los Angeles, Atlanta, Charlotte, Massachusetts, you name it, that say we want the ability to be homeowners. You can check them out. Their names, their addresses and their phone numbers are here.

So let me end the testimony by asking that these cards be put into the record, by asking that the NACA Avenger, which explains the NACA program, be put into the record; that all the homeowners on this map who purchased in Lawrence be put into the record.

The fact of the matter is, out of 583 NALA homeowners in Lawrence, only two people have lost their homes, only two people. These are people that Fannie Mae says should not get a loan, and the current delinquency is thirteen people, eight of which are only thirty days late.

I would say to Fannie Mae, beat that. No one can. It is a respect for working people that they don't show. So it is interesting to have a discussion here, but when you go out into the neighborhoods and out to the communities, Fannie Mae, supported by the taxpayers, is not doing it. Thank you very much.

[The prepared statement of Bruce Marks can be found on page 416 in the appendix.]

Chairman BAKER. Thank you very much, Mr. Marks.

Welcome back, no stranger to this hearing room, former Member of Congress and Member of this committee, representing the District of Columbia for some number of years, Walter Fauntroy. Welcome, sir. I understand you are here today representing the National Black Leadership Roundtable.

STATEMENT OF HON. WALTER E. FAUNTROY, FORMER DC DELEGATE, U.S. HOUSE OF REPRESENTATIVES; HEAD, NATIONAL BLACK LEADERSHIP ROUNDTABLE

Mr. FAUNTROY. Yes, and thank you so much, Mr. Baker and Members of the Committee. I want to thank you for giving me this opportunity to discuss in some detail what I summarized last week.

I do have to warn you that my remarks are those which are the result of the arrogance of old age and experience that has come not only from twenty years on this committee, but forty years seeking to declare good news to the least among us. So I am very clear on three things: one. that politics is the process of determining who gets how much of what, when and where in five areas: Who gets how much income generated; who gets how much education; who gets how much health care; who gets how much housing; and who gets how much justice.

I am also clear on something that Maxine Waters, our distinguished colleague, former colleague there, pointed out in terms of the extent to which over my years of experience at the court many changes in public policy that affect people of African descent whose experience in the area of housing reflects most acutely the mission that Fannie Mae and the GSEs were given, and that is that the 20th century has been a century of democracy, of corporate power and corporate use of propaganda to defend the corporations from democracy.

Now I understand that very well. So I understand what FM Watch is doing, and I understand what the two colleagues here at the table have experienced with respect to Fannie Mae. I am also very aware of the use to which those who want to deny income, education, health care and housing and justice to the least of these employ countervailing strategies by which they work out such things as I have seen in that plan, by which we say to people you are different from them; let's you and them fight, while we laugh all the way to the bank.

I have seen it in Africa. I have seen it in the Third World generally, and I have seen it here.

So having said that, I appear before you today in three capacities. The first is as President of the National Black Leadership Roundtable, the national network vehicle of the Congressional Black Caucus. It is composed of the heads of more than 200 national black organizations in 18 categories of American life. That Roundtable convenes twice a year to determine how best to support Congressional Black Caucus policy agenda initiatives designed to improve the quality of life in those five areas that I have talked about.

For guidance on matters of housing and community development, we rely heavily on two member organizations who are out there where the rubber hits the road in terms of affordable housing. They are the National Black Caucus of State Legislators and the National Conference of Black Mayors and its parent body, the World Conference of Mayors.

With your permission, I would like to enter into the record at this point letters sent to me on this subject of H.R. 3703 by State Representative James L. Thomas, who is President of the National Black Caucus of State Legislators, and the Honorable Johnny Ford, Founder and Director of the World Conference of Mayors and one who benefited from our struggle in the South to involve millions of people of African descent in the process of determining who gets how much of what, when and where, and who served for twenty years as the Mayor of Tuskegee.

He has led the State there to support Fannie Mae's efforts to remove remaining barriers to home ownership and to bring even more families close to the realization of the American dream.

They also oppose H.R. 3703, because it would, and I quote them, "impede future progress of increasing home ownership in this country."

Second, Mr. Chairman, I testify here today against the background of nearly twenty years that I spent on this committee, six of them as Chair of the Subcommittee on Domestic Monetary Policy and four of them as Chair of the Committee on International Development, Finance and Trade.

And third, Mr. Chairman, I testify against the background of these more than forty years as an inner city pastor here in the District of Columbia, a civil rights activist across the country, including the District of Columbia, and these mission-driven companies that have a role in accomplishing a very important objective for those of us who are concerned about housing for the least among us.

Having said that, Mr. Chairman, I would like then to move on to the question—if you will bear with me just a moment, I have lost one of my pages. Let me move on then just to point out that it is clear that in the effort to establish a program for making affordable housing available to people for whom the private commercial market was not providing that kind of access to mortgages and ultimately to second mortgages, we put in place in this subcommittee the Fannie Mae program, the GSE program and we are the first to admit that it has not worked as we were inclined.

There are two reasons that I am here. One is that I am so proud and appreciative of the role that this committee took in passing the Act of 1992, which redefined not only the mission and charter of the GSEs, but also placed them under regulatory authority of the one agency that is formed and designed to assure that America's people are affordably housed. I think they have done a reasonably good job since 1992, not enough, but the facts point out that our national ownership rate stands now at 67 percent; and a little closer to home here in the District of Columbia it has risen to 42 percent. And while a lot more needs to be done, I am pleased at the progress that has been made.

Minority home ownership during the 1990's grew tremendously, and that is not to say that much does not still have to be done, but the African American home ownership rate today is over 47 percent, up some 42 percent from 1993; and the Hispanic rate is up to 46 percent, up from 39 percent at a time when you passed a very important piece of legislation to harness the potential and the focus of the GSEs.

So it is clear that our GSEs are part of the answer to narrowing the home ownership gap and the rising rate of minority ownership of homes. These are significant results and these are results that should not be taken lightly, Mr. Chairman.

For that reason, I want to see that the reforms proposed do not limit what has begun to happen, and that is the tremendous encouragement that has come about, because HUD did set goals of 50 percent of Fannie Maes and the other business as serving low- and moderate-income families.

I will be watching to see if that continues to improve, and indeed have some plans right here in the District of Columbia to force the kind of cooperation between not only the GSEs, but all available Federal and private programs designed to provide affordable housing for the people of the District of Columbia.

A second reason I have been very much concerned is that there is a greater need today for this kind of mission than perhaps at any time since the charters were given. I refer you to the report of the HUD to the Congress this last March. In its report on the worst case housing needs of the country, it informed you that worst case housing has already reached an all time high of 4.5 million households that are unable to qualify for home ownership, and that is 600,000 worse than it was before you acted in 1992.

You ought to know that here in the District of Columbia that problem reflects itself most acutely than any other place in the Nation. In the last two years, Section 8 waiting lists in the District have increased by 29 percent. Our public housing waiting list is 24 percent. There is underway a process of the removal of low- and

moderate-income people from this city and many urban centers across the country that really cannot be allowed to continue.

The situation here and across the country would have been worse, I tell you, if we had not passed that 1992 Act, and I want to see the fruits of that Act borne before we move to dismantle. There is much more that needs to be done. We need to challenge these GSEs to clean up the predatory loan market for second mortgages. They need to come up with even more creative ways of making home ownership available to senior citizens on limited income, and moving more creditworthy and low- and moderate-income loan applicants from the C to D to A ratings, where those moves are warranted.

Once they become homeowners, our GSEs need to facilitate access to affordable, nonpredatory home improvement loans, such as they have begun to focus on since the Congress acted in 1992.

I would like to take a moment, Mr. Chairman, to challenge some of the points made by the critics of the GSEs. There are those who assert that GSEs should no longer exist, that whatever market field they were originally created to address has been remedied and that the private market without the GSEs can fully meet the financial needs of the country and the low- and moderate-income people who are still frozen out of home ownership.

I have listened to the arguments. Some of them are rather cute, but not correct, and some of the authors may be serious, but they are seriously wrong and sincerely wrong.

The fact is that it is precisely because the private market has not provided this mortgage lending that the Congress has seen the need to enact laws like the Community Reinvestment Act. It is precisely because this so-called private market, left to its own devices, will not serve certain segments of our communities, segments where it is perceived the risks are too high and the returns too low.

This is not to say that everyone can and should be a homeowner. It is just that the Congress determined that it was the appropriate thing to do to focus the resources of what we call GSEs on meeting this market.

I am disappointed, I have been disappointed for many years, that they were not doing it to the extent that I feel necessary, and I am pleased that the arrangement in 1992 has resulted in a greater focus and one that needs to be built upon rather than have these organizations dismantled.

The effort to dramatically change or privatize would mean, in my view, that the underserved would be even more underserved, and I await anyone's explanation of how that can be avoided.

I have heard complaints about Fannie Mae and mission creep, but Fannie and Freddie are just trying to do the job that the Congress gave them. For example, critics say that home equity loans are mission creep. Well, that is not mission creep. Home equity loans are an important part of the mission that we gave Fannie Mae, and I want them to get into it.

Today's fancy term "home equity loan" was and is a second mortgage. At least that is what we called it back in 1984 when I was here, and this committee explicitly added second loans or home equity loans to the list of products we wanted Fannie Mae to buy. We did this because it meant that second mortgages would come down

in price and having Fannie and Freddie in these markets, I think, lower consumer prices for those products, and that is good.

Others critics say that Fannie Mae and Freddie Mac are risky. This too is ridiculous. Fannie Mae and Freddie Mac are the best risk managers on the planet, as we know. Their credit losses are low.

Chairman BAKER. Mr. Fauntroy, if I can, you have been going for about fifteen minutes. If you can begin to wind it up, that clock with the numbers on it is just for five minutes over. It is not five minutes left.

Mr. FAUNTROY. All right. Let me then just briefly mention the criticism that Fannie Mae ought to be subjected to State taxes. As you know, we chartered these organizations to lower the cost of home ownership in all 50 States, and we did it to smooth out the regional imbalances in the mortgage supply and to integrate regional mortgage markets into the national capital markets, by creating a liquid secondary market for mortgages in all 50 States. Fannie Mae also lowers the exposure to banks and thrifts to regional downturns, and so I would not want to see that happen. I am pleased that we require them to pay Federal income taxes and to pay the local property taxes, as they do here in the District of Columbia. Although we in the District of Columbia are denied many of the same rights that citizens of the 50 States have, we do have that right and for that reason I would not want to see the institutions denied this ability to avoid the ability to smooth out the availability of mortgage credit and to smooth out the effects of downturns in various communities.

With that, I will just conclude my remarks and ask that you include in the record the correspondence to me from both the World Conference of Mayors and the National Black Caucus of State Legislators.

[The prepared statement of Hon. Walter E. Fauntroy can be found on page 425 in the appendix.]

Chairman BAKER. Yes, sir. Thank you very much. Every witness' complete testimony, as well as all addenda suggested by the respective witnesses, will be made a part of the official record.

Reverend Hagler and Mr. Marks, let me follow on to the precedence set in the earlier panel of witnesses to establish your motivation for being here today. Have either of you been requested by Fannie Watch or Fannie Watch-related interests to appear here today or to direct your testimony in any manner; or have you financially benefited from activities of Fannie Watch in your organizational interests?

Rev. HAGLER. No, I have not.

Mr. MARKS. Absolutely not, and we testified, both of us, four years ago in front of the DC Committee, and at that time spoke out against the Fannie Mae subsidy and stated that they should pay taxes.

Chairman BAKER. For the record, on the other side of the coin, Reverend Hagler, I assume that your organization has some time in the past had a financial relationship with Fannie and/or Freddie, is that correct? You no longer have a relationship?

Rev. HAGLER. No, that is not correct. We have had no relationship with Freddie or Fannie.

Chairman BAKER. Financial or otherwise?

Rev. HAGLER. Financial or otherwise; a relationship of advocacy trying to make them do the right thing, but that is not a monetary one.

Chairman BAKER. Given the suspicions that surround all these considerations, I think it is important to establish your perspectives. I took the liberty to assume your testimony was adverse to Fannie's and Freddie's interest. That is why I asked that question.

Mr. FAUNTROY. With the Chairman's permission, I would like to answer the question as well.

Chairman BAKER. Certainly.

Mr. FAUNTROY. Let me say that I have received no funding from Fannie Mae ever. I have never attended a conference of Fannie Mae. I have spent years in the trenches providing housing for low- and moderate-income people here and around the country through programs that have been supported on a bipartisan basis by both President Johnson and President Nixon, as my testimony shows.

So I am sincerely focused on the need to spare those who are being left behind in larger numbers now from the American dream, by market forces at work, market forces I see at work in this room given what I know about corporate power and corporate propaganda.

Chairman BAKER. Mr. Fauntroy, specifically I really wasn't asking about you personally. I was asking about them in their capacity in which they appear here today and their organizations.

You appear here today for the National Black Leadership Roundtable. That statement is true for them as well?

Mr. FAUNTROY. And for New Bethel Baptist Church, the church of my childhood, the church where I have been pastor for forty years and from which base I have engaged in civil rights activity and political action designed to properly distribute income, education, health care, jobs and justice among the least among us, too many of which are represented in the black community.

Chairman BAKER. And that statement with regard to the church and to the Roundtable is that, to your knowledge, neither Fannie or Freddie or FM Watch, to your knowledge, contributed to any of those?

Mr. FAUNTROY. I assure you FM Watch has not come to me.

Chairman BAKER. I kind of figured that.

Mr. FAUNTROY. You can rest assured that during my twenty years on this committee, I came to understand what I testified to in the record here about what Paul Volcker and Alan Greenspan taught me.

Chairman BAKER. To your earlier testimony of last week in which you were interested in some pilot project within the District, innovative housing opportunities to achieve that end, do you think it is ill-advised to ask the GSEs to contribute, since their corporate headquarters are located here, through some assessment toward District improvements?

Mr. FAUNTROY. We have a very serious problem in this country and I am experiencing it in my neighborhood, where people are being run out of this town, what we call Ward 9, and I want to do in the immediate future what we did thirty years ago, and that is to coordinate and concentrate all available Federal programs and

private sector programs on that problem, and for that reason I am going to be after everybody.

Chairman BAKER. Let me make sure I understand. Are you opposed to or do you support imposition of a fee or a tax on Fannie or Freddie on just their District holdings? I am not talking about a national tax.

Mr. FAUNTROY. No.

Chairman BAKER. Only to help the DC. housing market?

Mr. FAUNTROY. No. I am not for—I want it to carry out its mission, and its mission, while it exempts it from local or State taxes on income, does not exempt it from property taxes.

Chairman BAKER. Correct.

Mr. FAUNTROY. Therefore, I want them to pay their property taxes, and I want for the District of Columbia residents what every other citizen has, and that is access to Fannie Mae GSE programs designed to provide access to decent, safe and sanitary housing for people who have been left out of that access by the private sector.

Rev. HAGLER. Mr. Chair, I am sort of also listening to the testimony as you are, and I was curious, because I wanted to know an answer to a question, and that is whether the Roundtable received any grants, funds from Fannie Mae, Freddie Mac? And I wasn't sure if I heard that.

Chairman BAKER. The question I asked, because he is appearing today as the National Black Leadership Roundtable representative, I assumed that was the gentleman's answer, that they have not.

Mr. FAUNTROY. I want to make it very clear, absolutely not.

Chairman BAKER. That is what I understood.

Mr. FAUNTROY. I put in the testimony of two organizations that are a part of the National Black Leadership Roundtable, which is the Caucus Roundtable upon whom we lean for guidance; Conference of Black Mayors who have to deal with these problems in these cities every day; and second, the National Black Caucus of State Legislators, who recognize what would happen if States could tax income of the GSEs in terms of making sure that the money got spread around to the people who most need it at a time when their market conditions may not be favorable to access to credit for low- and moderate-income people.

Chairman BAKER. Thank you, sir.

I am going to go on just for a minute longer. I have one other question, since we have a limited number of Members who are here. Relative to a joint press conference by Secretary Summers and Secretary Cuomo, relative to recommendations to curb predatory home mortgage lending, I would like each of you just to respond.

There is a recommendation which I would intend to include in the construction of H.R. 3703, which is not today in H.R. 3703, which states that Congress should enact legislation to clarify as necessary the authority of HUD and Federal Housing Finance Board to prohibit through regulation Government-sponsored enterprises purchasing loans with predatory features.

Now I don't know exactly what that means, but would any of you have any objection to that inclusion in H.R. 3703?

Mr. MARKS. Absolutely. It needs to be put in. We would absolutely support it. There is absolutely no reason not to include it.

Fannie Mae is out there to maximize its profits. Their economic interest says if we can push someone who can get an 8 percent mortgage into a subprime loan and we can get 10 percent, we all know what Fannie Mae is going to do, because their job is to maximize their profits.

So absolutely, that is an important addition to the legislation, because the economics say they are going to constrain the conventional criteria to get 200 more basis points to get even more profits.

Chairman BAKER. Thank you.

Mr. Fauntroy, I would ask your response on that, but while I understand your testimony being concerned about obstructing the progress of these enterprises engaging in their mission, what in H.R. 3703, in your opinion, does that?

Mr. FAUNTROY. I think the Act of 1992 does all that needs to be done at this time. I think it—and I segue right into your last question, namely that I would support what HUD is recommending as freestanding legislation, for the reason that HUD is carrying out the mission that we gave it to regulate these GSEs and also to give them goals and targets that they must meet, and they have begun to do that.

Chairman BAKER. You would support whatever the regulators at HUD think is advisable policy?

Mr. FAUNTROY. That is right. I think that is their responsibility.

Chairman BAKER. I would point out for the record that HUD recently was significantly chastised by Members of this subcommittee for having reported that they felt that the underwriting criteria used by the GSEs resulted in, not that it was discriminatory, but it resulted in discriminatory lending practices by the GSEs and significant criticism was leveled at the GSEs by HUD for their failure to comply successfully with their mission goals. So I point that out.

Mr. FAUNTROY. HUD is doing their job. Leave them alone.

Chairman BAKER. We are almost close there. Good.

Rev. HAGLER. If I could also say one more thing in reference to the predatory lending piece, I think that it is very important that it somehow be embedded in there, because one of the things that has been in my experience, and, just like Reverend Fauntroy, I have been involved in the civil rights movement and other human rights-type movements in the world as well as in the country, but one of the things, alarming things I saw was Fannie Mae with its huge war chest basically going around into the lending-type advocacy communities and in the civil rights communities attempting to put forth a program of moving into subprime and predatory-featured lending, with the quiet fear there that if you disagreed with it you would be cut off from the grant mechanisms, and so forth, and so forth, that Fannie Mae and Freddie Mac came forth with. So that is a danger and that is a place where, in a sense, GSEs should not be in terms of trying to really quell public opinion and expression in that way to move into a market that brings more profit and unfortunately exploits millions of people.

Chairman BAKER. Thank you, sir.

Mr. Kanjorski.

I am sorry.

Ms. Waters.

Ms. WATERS. Thank you, Mr. Kanjorski, for allowing me to take this time.

I think it is probably only fair, and I am going to do this, to ask, Mr. Chairman, that I am able to insert into the record some information on behalf of Fannie, because of the statement that was made about them redlining in Lawrence. What they have sent here, and I will pass it on down to you, is documentation that they have financed a total of 1,056 single-family loans between 1995 and April 2000 in the City of Lawrence, supporting 1,600, and it looks like 50, houses of the 72.5 percent served households of low- or moderate-income, and 80 percent were located in lower and minority tracts.

So I would ask that in all fairness, I think probably should be included.

[The information referred to can be found on page 288 in the appendix.]

Chairman BAKER. That is without objection.

Ms. WATERS. Thank you. Thank you very much.

Mr. MARKS. If I could respond to that as well?

Ms. WATERS. I beg your pardon?

Mr. MARKS. If I could respond to that as well?

Ms. WATERS. No, I haven't asked you to. Thank you.

Let me just say that I really do appreciate your being here, because all of this is quite interesting to me and I am learning an awful lot. I don't know if you were aware of the fact that we had a financial services modernization bill that passed through here with Mr. Gramm literally ending up negotiating with this Administration in the wee hours of the morning and that they basically beat me out in trying to stop an attack on CRA and those of you who try and service CRA, because this whole business about transparency, I thought, was just an attempt to try and weaken the CRA organizations and it was a very painful experience for me. I really left that experience feeling quite put upon by Mr. Gramm and most of my Republican friends, including the Chair of this subcommittee where you are here today who opposed CRA, and CRA organizations, and the whole law that I try and desperately hang on to, because I believe that the work is important.

And so when I find the CRA groups in front of this subcommittee with Mr. Baker, I really have to try and understand what we are doing. I think we all have the same goals, that we want to have opportunities for people to be homeowners and we want the lenders, no matter who they are, whether it is Fannie Mae or the banks or the mortgage companies, to make these loans available. We want them to be available to minorities and to poor communities and we want a fair interest rate and we don't want exorbitant fees. We don't want predatory lending. I think we all share those goals and I think you do, too. But what I am finding out is as I fight through all of this and learn every aspect of this, and I intend to do that for the next however many years that I am here, I guess what I am finding is that we are all caught up in this spiral of lending by institutions, I guess good, bad and indifferent.

I take it that you—Mr. Marks, you are a CRA agency, is that right, nonprofit?

Mr. MARKS. We are a nonprofit organization.

Ms. WATERS. And you help to enforce CRA and create agreements with banks and lending institutions on behalf of the people you try and serve, is that right?

Mr. MARKS. We certainly take on predatory lending and fair housing issues.

Ms. WATERS. So what you have is you have some agreements with some banks?

Mr. MARKS. Yes, absolutely.

Ms. WATERS. Is that right? Which banks do you have agreements with?

Mr. MARKS. Bank of America, First Union, Fleet, others.

Ms. WATERS. And Fleet?

Mr. MARKS. Yes.

Ms. WATERS. Now, Mr. Marks, I didn't see you during the time I was getting my head caved in on the conference committee on the banking services financial modernization bill. Where were you?

Mr. MARKS. Well, with all due respect, Ms. Waters, when the issue of predatory lending came up and this organization was the one that put it on the national agenda.

Ms. WATERS. No, no, no, no.

Mr. MARKS. Excuse me. I am trying to answer your question.

Ms. WATERS. Mr. Marks, let me frame my question again. This was not about predatory lending. I am asking a specific question about, where were you?

Mr. MARKS. We had been——

Ms. WATERS. When they tried—Mr. Baker and his colleagues—tried to kill CRA, where were you?

Mr. MARKS. We were out there. We were contacting—we were doing the grass-roots organizing. Every once in a while, as you know, Ms. Waters, you have to get out of the Washington mentality and you have to organize on the neighborhood level. That is what we are doing with tens of thousands of people. You go in your district, in your district and you go to a NACA workshop where there are 300 to 400 working people, predominately minority, and you ask them and you stand up and we will give you any opportunity you want, and you can say you stand up for Fannie Mae because Fannie Mae says these people, our members do not deserve home ownership.

Ms. WATERS. Mr. Marks, reclaiming my time, reclaiming my time, Mr. Marks.

Mr. MARKS. Yes.

Ms. WATERS. I think I said one thing. I think that I gave you the benefit of the doubt in saying that you want to do good things. I think I said that. I asked you a specific question about where were you when I was getting my head kicked in trying to save CRA.

And I am going to move from that, because obviously you weren't here.

Rev. HAGLER. The reality is we would have been with you if there was an invitation. We have also been working on developing and making sure our offices functioned to the best of our ability to service the community. The same thing with NACA.

Ms. WATERS. Reclaiming my time. I did not ask you. I will get to you. Reclaiming my time.

Chairman BAKER. Gentlemen, if we can, just to have regular order here, the lady does control the time.

Ms. WATERS. You were not here either, and if you came unsolicited today I would expect you to come unsolicited when I am trying to save the ability for you to represent the people that you care about. That is all I am saying. If you ask me if I was hurt by that experience, that you were not here, yes, I am.

Rev. HAGLER. OK.

Ms. WATERS. Because I want to tell you, it is not easy to sit in this room at 12:00 or 1:00 in the morning fighting Phil Gramm, all of the Republicans, Democrats who turn on you and the Administration who even comes in and negotiates with Mr. Phil Gramm behind my back. So, now, having said that, Mr. Marks, it is all right for you to come here and criticize these GSEs. I don't care. As a matter of fact, a pox on everybody's house that is not doing what they should do for poor people and for people who deserve it.

But you sit here with agreements from Bank of America, First Union and Fleet, some of the worst. I remember when Fleet was in this room with horrible stories about second and third mortgages and how I had to take somebody from Fleet in the back and force them to let a gentleman out of a loan that they had refinanced many, many times and he was paying four times for a house what he started out to pay.

So what I ask you, if you are a part of or you know who is involved in FM Watch or whether or not you are participating with them in any way, I want you to know that all of the organizations that you have agreements with are a part of FM Watch, the Financial Services Roundtable.

So when you come here, I would expect that you would not only talk about what your problems are with the GSEs, I would expect you to talk about the predatory lending practices that Fleet was famous for and the fact that the Bank of America has redlined in South Central Los Angeles for many years and if First Union is the same First Union that I know about, they are now teaming up with Nick's Check Cashing in Los Angeles so that they can get involved in payday loans and predatory loans in the worst possible way.

Now, having said that, because I am learning all of this stuff, we have got some problems with everybody that you are in bed with. They are predatory lenders.

We have got problems with the GSEs, because we want them to do more. But one thing for sure, I can get Franklin Raines on the telephone, into my office, into my district, creating projects while I am banging him across the head to expand lending and increase their goals as they have just done.

Now, if you come in here and you take on the GSEs and you don't take on some of the worst in the industry, yes, it does make me wonder about what you are doing. These are the same people who want me to undo CRA. You are in bed with the enemy. You are in bed with the same people who say that we don't know what you are doing and you know what Mr. Phil Gramm said about you, he said that you guys were guilty of blackmail practically. He has used terrible words in these meetings.

Chairman BAKER. Ms. Waters, if you can begin to wrap up, the gentlelady has gone on now for some time.

Ms. WATERS. Yes, and I am going to—unfortunately these things happen this way. I am going to leave, because I have got to get to a meeting of the Congressional Black Caucus, and you won't have an opportunity to say much more than you have said. The facts are irrefutable.

Rev. HAGLER. Well, Congresswoman Waters, with all due respect——

Mr. MARKS. You should ask about the integrity——

Ms. WATERS. No, no. I am on my time, on my time. Reclaiming my time. I am reclaiming my time. This is on my time. Mr. Marks, this is on my time. Mr. Marks, this is on my time.

What I want to leave you with is this, I am your friend. I have taken some big blows for CRA. I have worked hard, and I continue to fight the very people that you end up having to do these agreements with. And all I want you to leave with is this: Just as you come unsolicited, as you supposedly have done today, and you are not a part of FM Watch and the strategy that they have developed around these GSEs, I want you to come to me unsolicited.

I have to tell you, I don't know who everybody is out there, but I expect when you read the newspapers and when you see the biggest bill of our lifetimes that is changing banking forever and ever in this country and CRA is at stake, I expect to hear from you. I expect you to be here with me. That is all I am telling you today. Just as you are here today.

Chairman BAKER. Thank you.

Rev. HAGLER. Can I have a comment before you leave, Congresswoman Waters?

Chairman BAKER. I think she is probably on her way to a meeting, but I would be happy to recognize you for a few minutes, if you choose to speak now.

Rev. HAGLER. Let me say this, the fact is that the so-called agreements only shows that you don't know who NACA is. NACA has fought tooth and nail each of these institutions around redlining and caused them to see the light, caused them to see what the problem is. And the fact that we created a structure to better deliver the services to those who are most in need and underserviced than even those banking entities is the reason that we are there.

We have always been in the trenches. We continue to be in the trenches. We have developed our offices in a meticulous way in terms that there is a glove treatment to every single client who walks through the doors absolutely free, and we work with them not only to repair their credit, but to deal with them so they can get the best deal and be able to stabilize their communities.

You know, so one of the problems here is the problem of pointing fingers and looking for demons under every rock. The issue, I would hope, is that everyone on both sides would inquire into the truth, to inquire into what are the realities out there and what are not the realities, to define what can make the systems work better and to ask the question of how do we begin to deliver the services that were probably—hopefully intended from the first to the people who directly need it.

We are not raising that. We are protecting one entity or we are trying to crucify the entity rather than coming down the middle

and inquiring on what is the truth and what really needs to be discerned here, and the truth that needs to be discerned here—thank you, Congresswoman. The truth that needs to be discerned here is that, yes, there is a lot of manipulation that has been going on, and really by the GSEs, because that is where we have experienced them.

Chairman BAKER. If I may, let me ask Mr. Marks to respond for a couple of minutes to get his comment on the record. Mr. Marks.

Mr. MARKS. It is true that Senator Gramm has called us "bank terrorists" and he has called us worse things than that. He has called us "extortionists," and we wear that as a badge of honor in the tradition of Robin Hood, if that is necessary to provide working people the opportunity to be homeowners, we are absolutely going to do that. If we have the banks who are working in partnership with NACA to provide $3.8 billion in the best mortgage product of the country, we wear that as a badge of honor. If you do not know our history, go back and see what we did in the four-and-a-half-year war against Fleet, in the campaigns against First Union, in the campaigns against a number of other institutions where we have gotten them to the table, where they have made agreements that meet the needs of working people. You have to focus on getting the job done, which is what NACA does versus what Fannie Mae and the other GSEs don't do.

It shouldn't be the fact that the major lending institutions in this country do more for affordable housing than taxpayer subsidized GSEs. That is the question. If a taxpayer is going to foot the bill, then the GSEs have to step up to the plate. We don't subsidize the banks. They don't have a charter with the Government that says they have to meet the needs of low- and moderate-income people. Therefore, Fannie Mae should do at least and more of what the other lenders out there do. They should disassociate, divest from the Government, both with its charter and with its subsidy, and compete with the rest of the lenders in this country.

Chairman BAKER. Thank you, Mr. Marks. Let me move on.

I am going to recognize Mr. Kanjorski in just a minute. I have a couple of comments I would like to make. I do think the proceedings, unfortunately, over the past couple of weeks have taken on an unusual tone; and last week some were questioning whether Ralph Nader was truly a consumer advocate. I found that somewhat noteworthy.

Second, today, although I may not agree with every activity the groups have engaged in, I don't consider myself a person who is out to destroy CRA, and I have respect for people who are in the real world trying to help poor people get into decent housing. I think that is a very laudible goal, and I commend both of you.

Let me also say I commend you for your courage for coming into this hearing room and saying on the record what you said. Whether we all agree with it or not, it is not a simple thing to do.

There is one other thing I want to bring up and I am saying this without anger, Mr. Kanjorski, so I don't want to start another fight, but it is serious. There has been distributed around the subcommittee hearing room today, to the media, a Dow Jones wire service story which indicates Members of this subcommittee have received significant financial contributions from Fannie Watch re-

lated interests, meaning a bank belongs to Fannie Watch. Therefore, if a bank gave a Member a contribution in 1992, there is an implicit relationship that this legislation is moving forward to advance the interest of Fannie Watch or those individual Members.

I am specifically mentioned in it. Mr. Kanjorski is mentioned in it, but at a far lower level. Let me come to your quick defense. You made the cut, but just barely. And there are a lot of other Democrats and Republicans. It is preponderantly Republican.

I note that one particular GSE representative has been distributing this during the course of the hearing.

Certainly anyone can question my motives, but I will say on the record, you can examine me from stem to stern and you will not find within me motivation to disrupt GSEs, the delivery of housing product or to be steered by financial contributions from anyone for any reason; and I think the fact that that information is being utilized has opened another door.

Mr. Fauntroy, can you tell me what relationship——

Mr. KANJORSKI. Mr. Chairman, I think I should ask for my five minutes.

Chairman BAKER. I recognize you for five minutes.

Mr. KANJORSKI. I listened to the testimony of the Reverend and Mr. Marks. I think I made a mistake when I bought a ticket for my return flight back from my district. I obviously said "Ozland," because I am listening to your testimony and you sound like virgins in Washington. I did not know there were any, but I am glad there are a few left.

You indicated in your testimony, Reverend, that something that really set you off was some funding that you were going to get from one of these GSEs. After you spoke your mind, however, the executive director said, "Thanks an awful lot for losing the $85,000 grant."

I do not want to get into all that, but that is what I understood. There was a motivation there.

Rev. HAGLER. Let me set the record straight, because you have got that fact wrong, so it is important to set that record straight.

It was a conference on the Community Reinvestment Act that Fannie Mae may have had partially underwritten. In that conference, the CEO, Mr. Johnson, spoke. We confronted Mr. Johnson as a participant in the conference, not applying for any grant from anybody.

Mr. KANJORSKI. I thought you said that after you got back——

Rev. HAGLER. No, I got it from the executive director of that coalition who said, "You see what you cost us by speaking out?" I don't have anything to do with that. I was a participant in the conference. I spoke the truth.

Mr. KANJORSKI. You made the assumption that that refusal of $85,000 was directly as a result of your statements?

Rev. HAGLER. I didn't make the assumption. That is what the executive director told me when I did call him.

Mr. KANJORSKI. He, of course, knows that because he lost the grant or he was in communication with the people who decided the grant. I am not going to argue that position with you. It just sounds rather naive to me that you think that it occurred. If it did occur, maybe we should examine all of those things in the future.

Mr. Marks, you are here as a CRA advocate. I have to tell you, when I came to the Congress of the United States, my record on CRA was rather clear. I opposed it. You probably convinced me today that I was right when I first came here. This last time when I decided to support CRA, I may have made a mistake. What you are telling me is there has been a tremendous reaction from the banking communities of America to do all these wonderful things without any compulsion of law. If you think that, you are the most naivé individual I have ever heard testify here.

The only reason you are getting the support of some of these banking communities is because CRA is in place. I did not think the idea of transparency was that bad, quite frankly, when we debated it during last year's conference on financial modernization. I had heard a lot of comments that CRA organizations were out there drumming up contracts and grants to keep them alive and to pay for their expenditures at the threat of stopping mergers, consolidations and other activities. That is probably as practical to make that judgment as the $85,000 grant that was a result of the ministers' statements, misstatements, or whatever.

Mr. MARKS. Mr. Kanjorski, may I respond?

Mr. KANJORSKI. I am going to let you respond. I do not normally defend Ms. Waters. She is much further to the left than I am, quite frankly, but to see organizations such as yours come in here and talk of—I think $3.5 billion of mortgaging, warrants such defense.

I commend you for doing that, but $3.5 billion, Mr. Marks, is not even a spit in the ocean for disadvantaged mortgaging in this country.

I could jump to the next logical conclusion of your argument, that of why we should not have CRAs. You have convinced me. The other testimony of the first panel here warrants that we ought to do away with GSEs. We never needed them to begin with. We really have done a disservice to the Congress of the United States. I think the private market out there would be doing everything that is being done today better and certainly more responsive to the poor and minorities of this country if we stepped out of the picture and repealed all the laws that we have in place. That is what I am hearing from your testimony.

Mr. MARKS. If I can respond, I appreciate the lecture on whether I know CRA or not.

I used to work for the Federal Reserve Bank of New York. I was in the domestic applications area. I dealt directly with the mergers and acquisitions of the major institutions in District 2. So while you were doing your piece, I was doing this at the Federal Reserve. I understand CRA, both how it was implemented when I was at the Federal Reserve Bank; I understand how the regulators look at CRA. I understand CRA is a good premise, very important, but it has no teeth.

We also understand that——

Mr. KANJORSKI. So we——

Mr. MARKS. I am sorry. If you could give me the respect that I gave you when I listened. The point I would like to say——

Mr. KANJORSKI. There are separate roles here, Mr. Marks. We call you to respond to our questions. We do not call you to give you

a platform, OK? If you want a platform, go outside in the square. That is where the television cameras are and you can speak there.

But, respond to our questions when you come in here, OK?

Mr. MARKS. It would be nice if they were factual.

Mr. KANJORSKI. I do not know that I have made any factual comments. I am drawing conclusions. I am listening to the testimony of witnesses, and what I gather from these witnesses is that we have done a terrible thing in this country for the last sixty years in creating GSEs. We have not solved the problem. The private market would have done a lot better, and one of the major mistakes we made in this country was passing the Community Reinvestment Act. I think maybe we ought to go back and rethink all these things. I think you persuaded me that you have the right answers and that your contacts and relationships with these major banks would have occurred in spite of what the Federal Government has undertaken. That the legislation, I think, has been visionary legislation over the last thirty or forty years to accomplish what we have arrived at. You probably have opened my mind.

I may think back to this day when we get into those rooms in the future and start negotiating and remember that we probably are holding you back. We ought to cut you loose into the private market. You would go crazy in that private market and take care of all these needs and all these standards you talk about.

Thank you, Mr. Chairman.

Mr. MARKS. If I could respond, with all due respect——

Chairman BAKER. You can on my time, but be brief, because I have got a few things to get off my chest.

Mr. MARKS. I will.

The fact of the matter is, absolutely CRA, sir, is important, but so are fair lending laws. So are the other laws out there. When NACA took on Fleet Finance, it was around the legal issue, around RESPA, fair housing. CRA, as you understand, is not enforceable except during a merger or an acquisition. It has to have more teeth. We understand that. We are out there taking on that fight. So obviously, CRA——

Mr. KANJORSKI. Mr. Marks, you do not take on that fight. The Congress of the United States passes that. That is the problem. What you have done is take a major step back, because you are starting to lose the support of people that you have in the Congress for the very thing you want to give teeth.

I will tell you what teeth was. If Mr. Gramm had his way, he would have pulled out every tooth in the mouth of CRA because it would have gone. I am not saying that you are right or you are wrong, or that other people are right or wrong. I am just saying, we should hear the testimony and jump on forty or fifty years of history in this country in progressive policy toward housing for poor people and average people. Nobody will claim that we had it right or that you had it wrong. You seem to be saying to me that you are the only person who knows how this thing works. It is not working because of the laws this Congress has passed, but it is working because you have been able to make these arrangements with all these banks. I would like to give you an opportunity to go back. Without the benefit of all these laws, go back and make that free market negotiation.

Mr. Marks, I tell you, if we did not have CRA and if you knocked on the door of any one of the three banks you mentioned, they would not even let you talk to the assistant, to the under-assistant, to the deputy assistant, to the treasurer of that institution. The only reason you are in there and have those agreements is a thirty- or forty- or fifty-year fight in the Congress of the United States to try and open this up.

Have we done it right? Not in its entirety. You come in here, however, attacking the policy and supporting the last table that was here. They want a flat tax. I guess we could say that you guys want it too.

Do you really want it? I guess I should ask that question.

Mr. MARKS. The focus is on GSEs. It is not on CRA. When you are in the affordable housing area, you develop coalitions based on the issue. This coalition is when some people on the Republican side and the Democratic side say that GSEs have to be held accountable.

Well, we develop these coalitions to keep affordable housing and mortgages for working people. So let's not confuse this with CRA. Let's keep the focus on what the GSEs subsidized by taxpayers have to do as per their charter. Let's not confuse the issue. Let's not blur the issue, with all due respect.

Mr. KANJORSKI. You come over to the floor this afternoon, and you watch whether the Majority party supports more money for the regulators of Fannie Mae and Freddie Mac. I assure you, they will not. We have to ask is there something that can be done today to make sure the mission is being carried out, and that the responsibility, safety, and soundness of the system is being protected? Are they going to support it? Is that amendment going to pass?

I will wager with you right now it does not pass.

Mr. MARKS. But the question is, are Fannie and Freddie doing what they are required to do, not whether CRA is there.

We will stand with you for CRA. We will stand against the people who are against that. But you should have the focus and the strength of your integrity to say, is Fannie Mae the solution or the problem? Focus on that.

Chairman BAKER. If I may try to get back in the game here, I have got a couple of minutes of stuff before we wrap this up. Again, I appreciate your courtesies in being here. I return to the subject of contributions to Members of the subcommittee in regard to their support or opposition to legislation. I just want to make clear, Mr. Fauntroy, does the National Black Leadership Roundtable have any leadership to the Congressional Black Caucus foundation or are they two separate enterprises?

Mr. FAUNTROY. Absolutely no relationship.

Chairman BAKER. What I wanted to bring to Ms. Waters' attention—and unfortunately, she has now left—for example, if we start following money and influence, the aggregate contributions to all Members, not one—on the Republican side, in the cited article, it was $250,000. Some are assuming that is going to influence Members' judgment on H.R. 3703. I can tell you it hasn't, but in 1998, the Fannie Mae Foundation—I may be incorrect about "Foundation," whether it is Fannie Mae—gave the Black Caucus Foundation $82,000, but in 1999 gave them $500,000.

Now, I don't think any of that has relevance to the considerations of this subcommittee, but I am saying to all parties, let's conduct a professional debate of the issue. Stop questioning each other's motives and why one appears for or against the legislation, and eventually we will vote on this proposal.

I started it with the premise that my work was based on recommendations of the CBO, the GAO, the Treasury, Alan Greenspan and a number of other people who happen to know more about this than I do. And if there are defects with the bill, I am perfectly willing to accept modifications.

In the case of predatory lending prohibitions, last week in taking the Community Reinvestment recommendation with regard to mission compliance and line-of-credit suspension, I think there are a lot of good ideas that have been promoted through these hearings to this point. My door is not closed to anyone. This is a work in progress.

And let's put down the accusatory attitude about the reasons for this subcommittee's work and see if we can't enhance consumer delivery of low-income product while at the same time protecting taxpayers from unwarranted risk. Those are absolutely the two points of this legislation. To the extent it doesn't achieve it, I am still waiting on the GSEs to deliver a document to my door that says how we get there. I haven't gotten it; I have asked repeatedly. They viewed the bill and its content before its introduction.

I am going to extend to Mr. Kanjorski in the next day or two an offer to have a study group plan, but I hope—on some rules of conduct that I hope he will find acceptable, because I want to open it up more. If there are more people who want to come in and tell us what is wrong with what we are doing, let's hear from them. We will have more hearings. I just hope the tone of the last hearing and this one can be slightly modified to where we can hear from people with differing opinions come to professional conclusions and make appropriate decisions for all parties.

To that, did you care to respond, Mr. Kanjorski?

Mr. KANJORSKI. No.

Chairman BAKER. I am saying this with the highest degree of sincerity. We have worked together on Home Loan Bank and a lot of other tough issues over the last decade, and I think it is time we focus on an appropriate manner of conduct for this subcommittee.

With that having been said, we will have a meeting in July for market participants.

This hearing is adjourned. Thank you.

[Whereupon, at 1:47 p.m., the hearing was adjourned.]

H.R. 3703—THE HOUSING FINANCE REGULATORY IMPROVEMENT ACT—PART 2

THURSDAY, JULY 20, 2000

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES AND GOVERNMENT SPONSORED ENTERPRISES,
COMMITTEE ON BANKING AND FINANCIAL SERVICES,
Washington, DC.

The subcommittee met, pursuant to call, at 10:12 a.m., in room 2128, Rayburn House Office Building, Hon. Richard H. Baker, [chairman of the subcommittee], presiding.

Present: Chairman Baker; Representatives Lucas, Ryan, Sweeney, Biggert, Terry, Toomey, Roukema, Royce, Cook, Kanjorski, Bentsen, Waters, C. Maloney of New York, J. Maloney of Connecticut, Mascara, and Jones.

Chairman BAKER. I would like to call this hearing of the Capital Markets Subcommittee to order and welcome all those in attendance.

The purpose of the hearing this morning is to receive testimony of those engaged as market participants in the delivery of home financing products to consumers.

When I began the review of the Government-sponsored enterprises a few years ago, my principal area of concern was then what would happen if market conditions changed dramatically and one of the GSEs became insolvent. Well, I was assured that that simply would not happen. After all, such circumstances would necessitate that every financial institution in the world would be in extreme duress. There would be regional economic dislocations of enormous proportions. The description sounded to me like Louisiana in the late 1980's.

Then I was reminded that Fannie Mae, frankly, was insolvent from 1979 to 1984, if you remember. Until after creative regulatory oversight and forbearance of taxes due, Fannie was allowed to grow its way out of its insolvency. This was a convenience not afforded to any S&L that I am aware of, at least not in Louisiana.

And so here we are in the year 2000 being told that the GSEs are above reproach, and that with such smart and capable people running the show we should not even examine the financial condition of these enterprises. Smart people who have operated a highly profitable enterprise, at least in the near term, should never be questioned. That certainly was the accepted view just before LTCM failed.

Afterwards, many said, "Why weren't the tough questions asked?" Some even suggested it was not critically analyzed because

of LTCM's unprecedented record of profitability until the market turned unexpectedly, but the market did turn. Smart people went bankrupt. Taxpayers barely escaped.

The only goal of this effort today and over the past months is to take whatever action is proper and necessary to ensure taxpayers will never again be called on to pay for ill-advised risk taken by any financial institution. The enormity of the GSEs, their scope in enterprise activity is, frankly, very hard to comprehend. They are literally everywhere in the financial marketplace domestically and internationally. If there was a misstep, the adverse consequences would extend far beyond the 24 percent rate of return shareholders currently enjoy.

On the other hand, other than the U.S. Treasury, no other financial instrument has benefited from such broad market acceptance, and all of this flows from the perceived Governmental guarantees.

Let me again state what I have said throughout this process. Today the GSEs are very well managed, profitable, and a significant contributor to facilitating home ownership for many people. But that does not obviate the requirement for appropriate regulatory oversight.

Like any business enterprise, they are not immune to business reversals. It is our responsibility, as Members of Congress, to examine the regulatory system and the consequences of failing to govern the current dominance of these activities.

To that end, we will hear today from significant market participants, those who may have direct financial relationships with the enterprises. Take realtors, for example. They have no direct adverse consequences if an enterprise would get into difficulty; however, as long as the GSEs facilitate access to low-cost mortgages, it is significant in earning next month's 6, 7, or 8 percent commission. The same is true for home builders. A product is more readily sold if there is a stable liquid mortgage finance industry.

Now, I can say these things because I am a home builder, developer, and a former member of the realtors. I say "former member." I think your enrollment numbers are inaccurate this morning. You want to reduce it at least by one. But I suggest, as a Congressman, that we have a higher obligation, that is to do no harm.

We should not, through neglect, allow pursuit of profit to turn into tragedy for taxpayers. Some have suggested that because there is even an inquiry into this subject matter that interest rates have gone up and potential home buyers have been locked out by the thousands. That is simply a lie. Let us examine the facts.

In June of 1999 Chairman Greenspan began his inflation-fighting battle, and to date he is solely responsible for raising interest rates 1.75 percent. I have not heard anyone suggest that he is irresponsible or unprofessional in his conduct.

According to Fannie Mae, or the realtors' testimony calculation, such an interest rate increase of 1.75 percent would lock out 311,000 home owners from potential home ownership. That is amazing.

Where is the outrage? I would be happy to facilitate a meeting to take up this tragic home ownership fact with Chairman Greenspan should the realtors, home owners, or GSEs have any difficulty in making such arrangements.

But let us not ignore the U.S. Treasury, which has expressed significant concerns about the GSE activities and endorsed significant portions of H.R. 3703. To date I have not yet said it, but I would like to commend them for their bravery. I find their analysis to be professional and responsible, given the obvious consequences of GSE failure.

As to the testimony today, anyone who suggests the proposal will result in ill-advised consequences will be asked to explain their reasoning for such a conclusion, as well as to suggest a more-appropriate remedy for the underlying concerns. Please remember that you are not responding to me on these matters of public policy, as offeror of the proposal, but rather you should meet the standards of the CBO, the GAO, the U.S. Treasury, and perhaps the Federal Reserve. And any response that is predicated first on maintenance of an industry sector's profits as opposed to protection of the taxpayers will not be necessarily received well.

After a brief review of the written testimony, please know that your constructive criticisms will be helpful in crafting an improved product, a modified H.R. 3703, and it is to that end that the conclusion of this process will work. Legislation to protect taxpayers and nothing less will be the end product of this process.

Mr. Kanjorski.

[The prepared statement of Hon. Richard H. Baker can be found on page 434 in the appendix.]

Chairman KANJORSKI. Thank you, Mr. Chairman. I think we can keep that membership in the National Association of Realtors, because if you leave, I will join.

Chairman BAKER. Better check the price. It is pretty pricey.

Mr. KANJORSKI. Mr. Chairman, thank you for the opportunity to speak at our fifth day of proceedings on H.R. 3703, the Housing Finance Regulatory Improvement Act.

In my opening comments today, I would like to examine where we have been since our last hearing, where we are now at this hearing, and where we are going in considering the many complex issues related to Government-sponsored enterprises.

At our last hearing, I questioned several of our witnesses about the need to provide the Office of Federal Housing Enterprise Oversight with the money it needs to regulate the safety and soundness of Fannie Mae and Freddie Mac. There is nothing more important than effective regulation so that we can prevent improper activities from occurring.

Each of the taxpayers' groups support providing OFHEO with the money that it needs as it works to implement its risk-based capital standard and improve its ongoing examination of GSEs.

Immediately after our last hearing we voted on the House floor on an amendment offered by Congressman Hinchey to the VA/HUD appropriations bill to restore $4.7 million in additional funds that the OFHEO director had requested for oversight. Unfortunately, the amendment failed by a vote of 207 to 211. All the Democrats on this subcommittee supported the amendment, which would have passed if just a few more subcommittee Members on the other side of the aisle had supported the measure.

From this vote, I must conclude that not only has the House not reached consensus on the need to strengthen the GSEs' regula-

tions, but also our subcommittee has not reached consensus on these matters, even though we have carefully studied them for many months.

At our previous hearings I have also noted that, in order for our oversight of GSEs to be fair and effective, we must work to ensure that our proceedings are well-crafted. Accordingly, I have requested that we convene roundtable discussions with representatives of all interested parties. A roundtable would promote fair, free, and vigorous deliberation by forcing the participants to challenge each other's assumptions and assertions. If we pursue any further action on H.R. 3703 in the 106th Congress, I hope that we will finally organize a roundtable to understand more completely the need for and implications of this proposal.

Moreover, in conducting any hearings on this matter I have said at past meetings that we must ensure that our panels are balanced, containing a multiplicity of interest viewpoints and a broad representation of individuals. I am, therefore, pleased that the representatives of the National Association of Home Builders and the National Association of Realtors, which I requested, are joining us today. I commend the Chairman for inviting them.

In addition to the knowledgeable market participants with us today, I would have liked to have heard from others on this matter. For example, the Independent Community Bankers of America has detailed for us an important perspective of the implications of H.R. 3703 on small banks, small towns, and the Federal Home Loan Bank System. In a letter that I received from its president yesterday, he indicates that his group believes the legislation would "result in higher mortgage rates and other loan rates to consumers, businesses, and farms across the country."

I have also received a letter on H.R. 3703 from the president of the National Association of Federal Credit Unions earlier this week. That letter encourages us to preserve the existing regulatory framework.

In order to improve the quality of today's proceedings, Mr. Chairman, I would request unanimous consent to submit for the record these and other letters that I have recently received from the national trade associations, State organizations, housing and finance companies, and other market participants.

Chairman BAKER. Mr. Kanjorski, all those documents will be included in the record without objection. I have my own unsolicited letters which I would also include in the record.

[The information can be found on page 446 in the appendix.]

Mr. KANJORSKI. Finally, Mr. Chairman, because we are in the waning days of this Congress with fewer than 30 legislative days remaining, I must ask where we are going in our deliberations over H.R. 3703.

During my opening remarks of each of our previous hearings, I have stated that we must move forward cautiously and carefully in our consideration of this legislation. We must not pursue a course of haste where wise men fear to tread.

Just as we have not reached consensus in our subcommittee on OFHEO's funding level, we have not reached consensus on any of the issues contained in H.R. 3703. I believe we should not create uncertainty for markets and regulators. I believe we should not ac-

cidentally raise home ownership rates. I believe that we should not mark up this bill this year.

In closing, Mr. Chairman, improving the efficiency and effectiveness of our Nation's successful housing finance system while protecting taxpayers from unnecessary risks are matters that require extensive study before our subcommittee contemplates any legislative action. A truncated process could lead to countless unintended consequences.

I look forward to continuing to work with you in examining this issue and hearing from our panelists today.

[The prepared statement of Hon. Paul E. Kanjorski can be found on page 444 in the appendix.]

Chairman BAKER. Thank you, Mr. Kanjorski.

Just for the record, I do have my letter to Mr. Gunther at the ICBA dated June 29th. Unfortunately, I didn't get a response to my letter, which, interestingly, on my copy is dated July 19th, but we have not been able to communicate timely with the ICBA. Certainly, we have no intent to keep any party from being heard on the subject. That only speaks to the need for more hearings.

[The information referred to can be found on page 435 in the appendix.]

Mr. Lucas.

Mr. LUCAS. No statement, Mr. Chairman.

Chairman BAKER. Mr. Ryan.

Mr. RYAN. I thank you, Mr. Chairman.

Let me just come off of what Mr. Kanjorski said. I think that OFHEO does need help and I think that what we are dealing with here is constructive. These hearings are constructive. To suggest otherwise I think would be to suggest that we are being irresponsible in our stewardship of taxpayer dollars.

It is not that the GSEs are bad actors in the marketplace. That is just not the case. I think that the structure is one where you have contradictory mandates, contradictory missions, A shareholder mandate and a Government, congressionally-chartered mandate, which many times can be contradictory toward each other. That is what we are trying to ferret out here.

The question that should be concerning the subcommittee is: are we doing a good job of providing liquidity in the housing market? Are we securitizing secondary market? And are we doing so without needlessly putting taxpayer dollars at risk?

That is the issue that we are trying to get to, in my opinion. I think that we can come together on issues of a regulator, whether it is OFHEO or something else, and hopefully we will be able to reach consensus on that issue so that we are adequately protected and assured that taxpayer dollars are not needlessly being placed at risk.

At this time, Mr. Chairman, I would like to ask unanimous consent to include in the record a letter and a submission from the Mayor of Milwaukee, John Norquist.

Chairman BAKER. That is John Norquist, the Democrat?

Mr. RYAN. Yes.

Chairman BAKER. OK.

Mr. RYAN. John Norquist, provocative Democrat, Mayor of Milwaukee, sent Members of the subcommittee here a letter and a

chapter from his book, and I would like to ask unanimous consent to have that included in the record.

Chairman BAKER. Without objection, certainly. Yes, sir.

[The information can be found on page 568 in the appendix.]

Mr. RYAN. With that, I will yield my time.

Chairman BAKER. Thank you, Mr. Ryan.

Mrs. Biggert.

Mrs. BIGGERT. No statement, Mr. Chairman.

Chairman BAKER. Does any other Member have an opening statement?

[No response.]

Chairman BAKER. If not, then we would proceed to receive comment from our witnesses this morning.

First, we welcome back to the committee room a former Member, Congressman Steve Bartlett, who is now serving in the capacity as President of the Financial Services Roundtable.

Welcome. We are glad to have you back.

STATEMENT OF HON. STEVEN BARTLETT, FORMER MEMBER OF CONGRESS FROM THE STATE OF TEXAS; PRESIDENT, THE FINANCIAL SERVICES ROUNDTABLE

Mr. BARTLETT. Thank you, Mr. Chairman. It is good to be here. I am here as President of the Financial Services Roundtable. Our Roundtable represents 100 of the largest financial services providers in the country. In addition to that, Mr. Chairman, I might note, while serving as Mayor of Dallas and, prior to that, as a Member of the Congress and on this committee, I have been quite active in the GSE issues. I, in fact, was quite active in the development of the legislation, the Enhanced Secondary Mortgage Market Act, in 1983 and 1984.

In that sense, I would say that, in my view, H.R. 3703 is in many ways an extension and improvement on the underlying lieutenant that we did with the Enhanced Secondary Mortgage Market Act back in the early 1980's. Indeed, I can say, both as Mayor and as President of the Roundtable as well as a Member of Congress, Fannie and Freddie provide a great deal of positive benefits to home ownership, and those benefits within the mission of providing liquidity to the residential secondary mortgage market are benefits that we ought to continue to promote and to encourage.

My sense is that this legislation, H.R. 3703, speaks to the non-mission activities, as well as to safety and soundness.

In that sense, Mr. Chairman, the Roundtable supports H.R. 3703. There are some areas of the bill that we would like to work with the subcommittee to improve, but we think that H.R. 3703 establishes a framework that will allow the regulatory agencies the proper authority to control mission expansion by the Government-sponsored enterprises.

Mr. Chairman, much of what I will say will be related to mission expansion. Our member companies in the marketplace believe that mission expansion, both today and projected into the future, is quite significant and, in fact, is and will become a quite significant problem that this subcommittee has, I think, the obligation and responsibility to address.

I do appreciate your leadership, Mr. Chairman, and the leadership of Ranking Member Kanjorski. I do believe that the role and mission and activities of GSEs deserve periodic reviews, and I commend this subcommittee for conducting that review.

Mr. Chairman, as an aside, I notice in your statement that no one had been calling for oversight hearings or reviews on the Federal Reserve raising interest rates. Should they choose to raise interest rates much further, you may want to reconsider that.

Chairman BAKER. I couldn't help that. I am sorry.

Mr. BARTLETT. Mr. Chairman, the Roundtable and our member companies are not opposed to all of the activities of the GSEs. As I said, Fannie and Freddie have played a key and extremely significant and positive role for several decades in providing liquidity to the mortgage markets.

Also, the Federal Home Loan Bank System should be commended. In particular, I would note—not the subject of this hearing, but the mortgage partnership program that the Federal Home Loan Banks have launched as a pilot, and now in rolling out, are positive. They improve the market and they ought to be encouraged and supported.

Mr. Chairman, the specifics are in H.R. 3703. First, establishing a sole regulator for both safety and soundness and mission containment, we see that as a positive, as a strength of this bill. It combines safety and soundness and mission regulatory authority into one agency.

Second, the bill would change the manner in which regulators are funded. It is a governance issue, but it is absolutely critical. OFHEO is subject to a highly politicized and quite unusual appropriations process as a regulatory agency, so we support H.R. 3703's establishing financial independence. We think that is critical to the stability of any regulatory agency.

Mr. Chairman, for the record, OFHEO is the only Federal financial safety and soundness regulatory that is currently subject to the appropriations process. That should be changed immediately by the Congress and as quickly as you can.

Third, mission containment. This legislation would put into place a process long overdue for regulatory authority—in this case OFHEO—for new activities the GSEs wish to undertake. The approach proposed in the bill—candidly, Mr. Chairman, the details of it may be overly restricted or overly complicated, but we do very strongly agree with your intent and we would like to work with you on ways to perhaps simplify the approach.

I could give you examples. Two examples come to mind, examples of activities that Fannie and Freddie have undertaken that go beyond the original intended mission. Fannie, for example, has a program to buy home equity loans. One specifically that I think you have cited is Home Depot stores. Home equity loans, in fact, are used for all kinds of things other than buying homes. We think the role of the GSEs should be in home ownership and home purchases, liquidity in the residential secondary mortgage market.

Home equity loans are good things. They are used for good things of consumer credit, debt consolidation, college loans, purchasing new automobiles, or boats, or other goods, or windows and doors

at Home Depot stores. We think those are good things, but those good things should not be financed by GSEs.

Second mortgages were explicitly permitted in the mission statement, and home equity loans one could argue fall into that category. My belief, Mr. Chairman—and I was there—is that second mortgages back in 1983 and 1984 were generally thought of as things to help someone buy a home. Second mortgages now are for all other purposes, and we think that is an area that the subcommittee should focus on.

Another example, Freddie Mac has what is called a "Home Steps Buying Center," a storefront in a California strip mall where consumers can arrange to visit homes, receive financing, and close the loan. The program is promoted as a new way to buy a home—way beyond the mission of the residential mortgage market.

Fourth, Mr. Chairman, H.R. 3703 places limits on non-mission assets and it creates a framework for regulatory containment of the mission. Mr. Chairman, I would suggest, as you consider this legislation, the subcommittee may also want to look at the precise language of the statutory mission statement to try to bring the mission in the statute back to something that is much more current and closely mirrors what Congressional intent is in the current economy.

Fifth, safety and soundness. The Roundtable supports those provisions that require the GSEs to be rated by two nationally recognized rating agencies. GSEs do have an implicit Government guarantee beyond the explicit benefits afforded that are in the statute. Requiring this analysis will help to quantify for policymakers that implicit guarantee and promote greater transparency in the debt market.

Finally, Mr. Chairman, we support the changes to the statutory requirements, a simplification of the statutory requirements for risk-based capital. Mr. Chairman, an eight-year delay after the statute was written in promulgating final regulations essentially means that there is something wrong with the statute. It doesn't take a regulatory agency eight years to promulgate regulations for safety and soundness, so I think it is a per se case that that section of the statute is broken and needs to be fixed.

So, Mr. Chairman, in conclusion, one, the Roundtable supports Fannie Mae and Freddie Mac and the Federal Home Loan Banks in their core mission of providing a liquidity in the secondary residential mortgage market.

Two, we believe that Fannie and Freddie specifically are going way beyond their core mission and in an accelerated way that will only make the situation worse in coming years.

Third, we support H.R. 3703 in its mission containment and safety and soundness.

And, last, we will work with the subcommittee for specific improvements in the language of the bill that we think will make it work better.

Thank you, Mr. Chairman. I yield back.

[The prepared statement of Hon. Steven Bartlett can be found on page 488 in the appendix.]

Chairman Baker. Thank you very much for your attendance and your contribution.

Our next witness is Mr. Dennis Cronk, a partner in the real estate group domiciled in Roanoke, Virginia, and who appears here today in his capacity as President of the National Association of Realtors. Welcome.

STATEMENT OF DENNIS R. CRONK, BROKER/OWNER, WALDVOGEL, POE & CRONK REAL ESTATE GROUP INC., ROANOKE, VA; PRESIDENT, NATIONAL ASSOCIATION OF REALTORS

Mr. CRONK. Thank you, Mr. Chairman and Members of this subcommittee. I am Dennis Cronk, a realtor from Roanoke, Virginia, and President of the National Association of Realtors. I represent 760,000 realtors from around the country. It is, indeed, an honor to be here this morning to offer some views on H.R. 3703.

H.R. 3703 addresses many issues surrounding GSEs, but realtors focus really on one primary issue: is this legislation, as it is presently written, in the best interest of America's homeowners.

Let us begin with some facts.

Today, two out of every three American households own their homes, more than any time in history, and 42 percent of the buyers in 1999 were first-time home buyers.

Not only does this mean millions more Americans are realizing the American dream of home ownership, but their purchases help drive U.S. economy and the housing market, making it possible for existing owners to trade up to a new home.

Last year, more homes were purchased in America than ever before. One out of every nine American families either bought or sold a home last year. Yesterday, I returned from a meeting with real estate leaders in Japan, Hong Kong, and Beijing, and we as an association are working with partners in forty nations around the world to help build an orderly real estate market in their economies.

From my personal experience and discussions with all these real estate experts in the various countries around the world, we are, indeed, the envy of the world when it comes to the mortgage finance system. This really is due in no small part to the mortgage investment activities of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. In establishing Fannie Mae and Freddie Mac, Congress charged these enterprises, as a matter of public policy, to facilitate a secondary mortgage market with full knowledge of the risk associated with tying up capital and long-term fixed rate instruments. I commend Congress for that back in the early 1980's, as you can imagine what it has done to our market today.

This financial innovation created and maintains efficiency and liquidity in an otherwise inefficient and illiquid mortgage investment market.

In the nearly thirty years of their existence, Fannie Mae and Freddie Mac have fulfilled that Congressionally chartered mission in good economic times and bad. Realtors know from experience that current long economic expansion that we enjoy today will ultimately slow down, and when it does we also know that Fannie Mae and Freddie Mac, unlike the primary market lenders out there, will be there for us and for home buyers as they have been in the past.

The GSEs were created to do what no fully private company could do or was willing to attempt in return for their Government charters and other benefits. Congress limited the GSEs to a single line of business. Today, we hear these other financial institutions out there who are seeking to change radically the role of the GSEs, even to the point of stripping away their federally-chartered benefits. They argue that Fannie Mae and Freddie Mac have an unfair advantage because of their federally-chartered ties. Yet, I ask you, are any of these critics willing or capable of taking on the risks associated with making the secondary mortgage market work? Are they willing to be limited to a single line of business? Are they focused on making the home buying process more efficient and affordable for homeowners? Or are they focused on enhancing their own bottom lines at the expense of American homeowners?

Of the many provisions in H.R. 3703, we agree that the current regulatory framework in overseeing the GSEs should be revised to create a single, strong, independent regulatory authority.

The reform under consideration would effectively hamstring the GSEs, leaving them vulnerable to some strong oversight requirements that would stifle competition between them and reduce their effectiveness as mortgage investors. Any regulatory reform, we hope, that is developed must preserve innovation for the mortgage delivery system.

Despite realtors' general support for the GSEs, we have had our disagreements with Fannie Mae and Freddie Mac. We strongly disagreed with them two years ago when they opposed the increase in FHA mortgage limits. We did resolve that issue.

Today, we do disagree with some of their current efforts to expand foreclosed property disposition activities to include bidding on properties foreclosed by third parties.

There is no doubt in the future we will have differences with the GSEs, but I trust that we never lose sight of the goal we share together in bringing home ownership within the reach of all Americans.

For that reason, the National Association of Realtors urges this Congress not to risk derailing a system with a twenty-year record of delivering real value to American people.

Mr. Chairman, realtors have vivid and painful memories of how a well-meaning reform can have unintended consequences. The 1986 Tax Reform Act nearly destroyed the real estate market and our economy. My fellow Virginian, Thomas Jefferson, once said, "The hole and the patch should be commensurate." This legislation, as it presently is written, is extremely complex, addressing a variety of issues, each of which could be a single bill. Let us find a patch for the one hole that may need mending, assuring that there is a strong independent regulator for the GSEs and leave the other patches in the sewing kit, because they just simply aren't needed.

Thank you.

[The prepared statement of Dennis R. Cronk can be found on page 496 in the appendix.]

Chairman BAKER. Thank you, Mr. Cronk.

Our next witness this morning is Mr. Christopher Sumner, who is the CEO of a mortgage company in Salt Lake City, but appears

today in his capacity as President of the Mortgage Bankers Association of America.

Welcome, sir.

STATEMENT OF CHRISTOPHER J. SUMNER, CHIEF EXECUTIVE OFFICER, CROSSLAND MORTGAGE CORPORATION, SALT LAKE CITY, UT; PRESIDENT, MORTGAGE BANKERS ASSOCIATION OF AMERICA

Mr. SUMNER. Thank you, Mr. Chairman, Congressman Kanjorski, Members of the subcommittee. My name is Christopher Sumner, and I am President of the Mortgage Bankers Association of America and also the Chief Executive Officer of CrossLand Mortgage in Salt Lake City, Utah.

Mr. Chairman, let me first commend you and the subcommittee for tackling the issues before you during this time of calm economic seas. In the area of GSE safety and soundness, there is today no crisis upon us, but by acting now you are clearly demonstrating tremendous foresight in leadership.

The MBA—the Mortgage Bankers Association—appreciates the opportunity to be represented today. The MBA is an industry association with approximately 3,000 members of the real estate finance community, and our primary market lenders work to put families in homes and apartments and play a critical role in facilitating home ownership and rental housing.

Mr. Chairman, we believe that the reason Fannie and Freddie were established is as valid as ever: to ensure dependable liquidity for a stable secondary market, particularly for single-family, long-term, fixed-rate mortgages.

The GSEs have not outlived their original purpose. At the same time, it is essential to ensure that they do not outgrow it by entering primary markets already characterized by robust private sector competition.

The two markets, primary and secondary, depend on each other. In fact, for a viable secondary mortgage market to exist, a robust and competitive primary market is essential. Competition is the key to development of innovative products and to achieve the most efficient delivery of the lowest-cost residential mortgage credit.

Last year the primary market generated almost $1.3 trillion in home loans and $40 billion in loans for multi-family developments. Our members have a strong commitment to the present mortgage finance system, but we are concerned that the essential stability of this system could be undermined if the unprecedented growth of Fannie Mae and Freddie Mac results in an expansion of their activities beyond the mandate intended by Congress.

By expanding beyond the intended boundaries of their charter, the GSEs could upset the equilibrium between the primary and secondary markets. The immediate casualties might be existing mortgage providers, but consumers would be the ultimate losers. Less competition means higher borrowing costs, fewer financing options, and less responsiveness to consumer needs.

The MBA believes that a well-funded, independent regulator of the GSEs is necessary to maintain this delicate balance designed by Congress. We believe that the statutory guidance is required to ensure a clear separation between the roles of mortgage lenders

and the GSEs and to prohibit the GSEs from engaging in primary mortgage activities.

We believe that oversight must also be structured so as not to interfere with the smooth operation and efficiency of today's market.

The MBA wants to be a constructive partner with this subcommittee in its review of GSE oversight, and toward that end, Mr. Chairman, I am pleased to advise you that the MBA has convened a blue ribbon task force of mortgage company executives to examine the boundaries of secondary market activity. We aim to develop an appropriate definition that preserves the equilibrium between the markets which have served the American consumer so well.

In a model of cooperation with the mortgage industry, both Fannie Mae and Freddie Mac have agreed to participate with us in this dialogue about the boundaries of the secondary market, and our goal is to produce a report with the MBA's view for review by you this fall.

Lenders, consumers, and the GSEs all share a mutual interest in maintaining the balance of the primary and secondary markets. Working together with this subcommittee and the GSEs, we have a unique opportunity to clarify Fannie Mae's and Freddie Mac's role as supporters of the primary market, but not competitors in it. This will ensure the continuation of robust competition that keeps borrowing costs down and home ownership up.

Mr. Chairman, my written statement provides additional detail on all of these issues and comments on the specific provisions of H.R. 3703. We hope to be a continuing resource for this subcommittee and your work in this important matter as it moves forward.

Once again, Mr. Chairman, thank you very much for the opportunity to talk before you today.

[The prepared statement of Christopher J. Sumner can be found on page 505 in the appendix.]

Chairman BAKER. Thank you, Mr. Sumner.

Our next witness this morning is Mr. Bruce Smith, who is President of Smith Quality Homes, Walnut Creek, California, who is here today, however, in his role as First Vice President of the National Association of Home Builders.

Welcome, sir.

STATEMENT OF BRUCE C. SMITH, PRESIDENT, SMITH QUALITY HOMES, WALNUT CREEK, CA; FIRST VICE PRESIDENT, NATIONAL ASSOCIATION OF HOME BUILDERS

Mr. SMITH. Thank you.

Chairman Baker, Mr. Kanjorski, my name is Bruce C. Smith. I am a home builder from California and President of Smith Quality Homes, a family owned business that my brother and I run that my father started in 1934 in Berkeley, California. I am also the First Vice President of the National Association of Home Builders, whose 200,000 members are proud of their contribution to housing Americans and housing millions of citizens who are renters in our country.

Through these hearings, NAHB supports your desires to ensure a strong, independent, effective regulatory structure for the hous-

ing-related Government-sponsored enterprises, GSEs—Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System.

The National Association of Home Builders believes that the current regulatory structure is accomplishing these objectives. America's housing finance system works incredibly well, and, as mentioned before by Dennis, indeed is the envy of the world.

Much of this success is due to the public/private partnership established by Congress more than half a century ago and to the reforms enacted in the Federal Housing Enterprise Safety and Soundness Act of 1992, the GSE Act, and, as well, the Graham-Leach-Bliley Act passed just last year.

I will confine my comments to three provisions in the bill.

First, the bill would consolidate the regulation of housing GSEs into a new, independent agency. The National Association of Home Builders has no quarrel with the concept of a single, more-efficient mission and safety/soundness regulator, but we question whether the structure envisioned by the legislation would be an improvement over the existing structure.

As stated before, we are certainly willing to participate in efforts to examine changes to improve the current system, but in the process we ask that great care should be taken not to impair important regulatory efforts underway or the ability of GSEs to attract capital to the housing finance system.

For example, there could be an unnecessary delay in the publications of final risk-based capital regulations for GSEs, a rule which NAHB and the entire community have been working for so long. Likewise, in the case of the Federal Home Loan Banks, work has just begun on revisions to the system's capital structure mandated by last year's modernization act.

Our second concern focuses on revisions to the current approval process for the new GSE activities. This provision is well intentioned and presumably would address such charter issues. The National Association of Home Builders certainly agrees that GSEs should operate within their Congressional charters. We believe that the current regulatory approval process is adequate to address those concerns. Specifically, the HUD secretary has already the authority to disapprove programs consistent with the GSE's charter or not in the public interest.

The National Association of Home Builders believes that the GSEs have demonstrated a particular expertise in identifying market needs and responding efficiently. We fear this provision would subject the GSEs to an unnecessarily cumbersome approval process that could have a chilling effect on the market innovation and impede the flow of new products and programs to meet the new demands of housing in our country. Ultimately, we believe that this provision could hurt the housing consumer.

Finally, the bill proposes to repeal Treasury's discretionary authority to purchase \$2.25 billion of Freddie Mac and Fannie Mae securities and \$4 billion cumulative of obligations to the Federal Home Loan Banks. This authority, which has never been used, is an integral feature of GSE status that provides Fannie Mae, Freddie Mac, and the Federal Home Loan Banks with their key benefit—the ability to raise capital at rates that benefit homeowners and renters throughout our Nation.

All of us are aware of what happened in the financial markets following the March hearing and the lingering effects that we have here today. These events are a clear demonstration of the importance of Treasury's security purchase authority to the financial market participation of GSEs and the potential for unintentional damage from possible changes.

We urge Congress to carefully consider the consequences that the elimination of this key pillar of GSE agency status could have on housing finance systems and the cost of home ownership.

As I said at the outset of my remarks, we believe that the housing finance system works incredibly well, due largely to the critical support provided by the housing Government-sponsored enterprises; however, we appreciate the subcommittee's efforts to assess and seek to improve to the regulatory framework of GSEs, and we are most interested in continuing to participate in this process as you move forward through your hearings and deliberations.

Thank you.

[The prepared statement of Bruce C. Smith can be found on page 539 in the appendix.]

Chairman BAKER. Thank you, Mr. Smith.

For the record, I am the initiating founding President of the Central Area Home Builders Association a few years back, so I have enjoyed my relationship with the home builders over the years. I am not a member, but that has nothing to do with the current legislative determinations.

I would announce for the benefit of the Members that we will recess briefly for the pending vote. In fairness to you, Mr. Bochnowski, for your appropriate presentation of your testimony, we will return as soon as possible. And notify Members that I will reconvene the hearing as promptly as I can return in order to facilitate our progress.

We stand in recess.

[Break.]

Chairman BAKER. Additional Members will be returning as business is concluded on the floor.

When we recessed, I was about to welcome Mr. David Bochnowski, who is Chairman, President, and CEO of Peoples Bank in Munster, Indiana, appearing here today as the First Vice Chairman of America's Community Bankers.

Welcome, sir.

STATEMENT OF DAVID BOCHNOWSKI, CHAIRMAN, PRESIDENT, AND CEO, PEOPLES BANK, MUNSTER, IN; FIRST VICE CHAIRMAN, AMERICA'S COMMUNITY BANKERS

Mr. BOCHNOWSKI. Mr. Chairman and Members of the subcommittee, I am David Bochnowski, Chairman and CEO of Peoples Bank of Munster, Indiana. I appreciate this opportunity to testify on behalf of America's Community Bankers.

The GSEs raise issues that are of great interest to our members. Virtually all of ACB members view residential mortgage finance as a core business activity. We commend you for taking on these challenges and important issues.

The GSEs are an important part of the housing finance system. ACB supports Fannie Mae, Freddie Mac, and the Federal Home Loan Banks and the role they have played. We also support a public policy review of Fannie Mae's and Freddie Mac's activities and role.

Legislative proposals must effectively authorize and require the regulators of the GSEs to engage in appropriate mission and safety and soundness and supervision. GSE activities should not subsume or discourage competition between current private sector participants. Regulation of the Federal Home Loan Bank System should not be consolidated with that of Fannie Mae and Freddie Mac. The Federal Home Loan Bank System is a cooperative system, while Fannie Mae and Freddie Mac are publicly traded companies. They require separate and different regulation.

America's housing and finance system is a mixture of private sector and Government-supported organizations and initiatives. This unique synergy has helped put a record number of Americans in homes. This should not be changed. The private sector community lenders must continue to bring people to the table as the lenders tied to the community, and the GSEs should continue to assure that a vibrant secondary market exists. It is the possible change in the balance of these activities that concerns ACB.

As important as the GSE roles are, they do not, in themselves, put a single borrower into a home. It is the primary market lenders like ACB members that deal directly with home buyer and borrower.

Fannie Mae and Freddie Mac provide elements of both cooperation and competition to the typical ACB member. The term "coopetition" that is sometimes used to describe this system of shifting alliances in a high-tech, new economy may aptly express these mixed emotions.

The Congress and the regulator for Fannie Mae and Freddie Mac must exercise vigilant oversight to be sure that the subtle balance between the GSEs and private market lenders is not upset. This requires an ongoing process, not occasional attention.

It is the evolution of Fannie Mae and Freddie Mac that is ACB's primary concern. In addition to meeting their mission as publicly traded companies, the two GSEs must also focus on shareholder returns. As a result, we are concerned about mission creep that can discourage or subsume the roles of other mortgage market participants.

ACB opposes any expansion of Fannie Mae and Freddie Mac into the home equity line of credit market. It is not consistent with promoting home ownership. Borrowers seeking to tap home equity have already achieved home ownership.

Activities that diminish the roles of other participants in the mortgage market should be prevented. The cooperative structure of the Federal Home Loan Bank System serves as a built-in safeguard against this. Fannie Mae and Freddie Mac, on the other hand, owe a fiduciary duty to their wide shareholder base and may be compelled to look for new markets to serve the interests of their shareholders.

ACB members have always been innovative, and the GSEs have been innovative, as well. Legislative and regulatory review must

ensure that GSEs' innovation does not create exclusive relationships. A better program review process might have prevented some of these concerns that have arisen from the HTI joint venture with Freddie Mac, Microsoft, and a limited number of large lenders.

ACB has had a number of discussions and has exchanged letters with Freddie Mac about HTI. We have also sent letters to OFHEO and HUD asking for a detailed program review. ACB is concerned that the venture does not have an open architecture, allowing any lender willing to pay a commercially reasonable price for the system to use it. No GSEs should be engaged in a venture that prefers one group of lenders over another group of lenders.

On another issue, ACB believes the risks associated with GSEs level of debt currently in the marketplace are appropriate. Still, Congress and regulators should be concerned with possible systemic risks and should be prepared to deal with potential problems if they arise.

ACB believes that legislative and regulatory diligence in maintaining appropriate capital adequacy and mission focus can address the issues of exposure to the taxpayer.

ACB supports Chairman Baker's introduction of H.R. 3703. Our written testimony goes into greater detail, but let me give you a brief overview of our views.

ACB supports the consolidation of both mission and safety and soundness oversight in a single regulator for Fannie Mae and Freddie Mac.

ACB is opposed to consolidating Federal oversight of the Federal Home Loan Bank System with the regulation of Fannie Mae and Freddie Mac. The Federal Home Loan Banks and the other two GSEs have vastly different natures and necessarily different risk-based capital requirements.

ACB is strongly supportive of providing the regulator of the GSEs with strong supervisory authority. We strongly support requiring new program activity review and approval. The manner in which a new program approval process is crafted, however, is complicated. The GSEs do have a legitimate concern about their need to maintain confidentiality for proprietary information and the need to move quickly in today's fast-moving markets.

The concept of modest initial holdings or of pilot program status may be a way to address these difficult issues. This would allow some interim status short of full approval. Such a process might have helped prevent the concerns that now exist regarding the HTI issues discussed earlier.

ACB believes that a clearer definition of Fannie Mae's and Freddie Mac's mission would be helpful. Unlike the Federal Home Loan Bank System, whose cooperative structure effectively creates checks and balances on the activities of the banks, Fannie Mae and Freddie Mac have an incentive to seek out new activities and markets to maintain or improve returns to shareholders.

ACB opposes creating uniform capital standards. It is important to recognize the differences between the cooperative structure of the Federal Home Loan Bank System and the publicly-traded corporate structure of Fannie Mae and Freddie Mac. Risk-based capital standards must be based on the GSEs' different missions or business approaches.

ACB does not support repeal of the Treasury line of credit. Eliminating the Treasury line of credit would be expected to increase residential mortgage costs.

ACB strongly opposes the repeal of the Federal Home Loan Banks' superlien authority.

ACB supports the sense of Congress calling for the approval of proposed rules issued jointly by the Federal Reserve, FDIC, OCC, and OTS to address the treatment of privately issued mortgage-backed securities under risk-based capital requirements.

I would like to take a few minutes to discuss some important Federal Home Loan Bank System issues.

ACB greatly appreciates and supports the leadership you, Mr. Chairman, and Ranking Member Kanjorski have taken in this area. Congress required the Federal Housing Finance Board to have capital regulations completed by November 12th. Development of the new capital structure has proven to be very complicated and many questions remain unanswered. To ensure that the Federal Home Loan Banks and the current and prospective stakeholders of the system have all of the necessary information available to develop and submit informed comments on the proposed rule, ACB and approximately twenty State trade associations sent a letter to you and a number of your colleagues requesting an extension of the date that the Federal Housing Finance Board has to complete the capital regulations. We hope the Banking Committee will direct the Federal Housing Finance Board to extend the process until the outstanding questions can be answered.

On June 29th, the Federal Housing Finance Board adopted a regulation that defines core mission activities and removes the cap and pilot status of the mortgage partnership type programs. ACB opposed the core mission definition because it suggests future investment or activity quotas. We believe that the mission of the system is clear in the statute and that the Federal Home Loan Banks and their members are in the best position to determine how to achieve that mission.

ACB supported removal of the caps and pilot status of the mortgage partnership programs. These programs should be allowed to earn their way into the balance sheets of the Federal Home Loan Banks. Recently we have learned that on the Senate side an amendment may be offered that would, in effect, put retroactive caps on these programs.

We believe it would be wrong for the Finance Board to mandate specific minimum levels for mortgage partnership or other programs at each Federal Home Loan Bank, and it would be equally wrong to impose legislative limits on the mortgage partnership programs.

Mr. Chairman, ACB believes that H.R. 3703 is an important and timely legislative initiative and raises public policy issues that must be addressed. The size and scope of the GSEs raise fundamental questions both for the structure of housing finance in America and for the safety of the marketplace.

The consumer deserves competitive opportunities in a secure marketplace and the taxpayer demands that risk to the Government be managed and minimized.

Thank you for this opportunity to testify.

[The prepared statement of David Bochnowski can be found on page 551 in the appendix.]

Chairman BAKER. Thank you very much, sir, for your constructive testimony.

Mr. Cronk, are you familiar with an organization called "Corey Savings Bank"? Does that ring a bell?

Mr. CRONK. Corey Savings Bank?

Chairman BAKER. Yes.

Mr. CRONK. Yes. They had a branch in Roanoke, Virginia.

Chairman BAKER. On West Church Street. You know what happened to them?

Mr. CRONK. They went under.

Chairman BAKER. That is right, in the 1980's, my point being the fact that it can happen in your own home town, it can happen anywhere. Do you believe that these GSEs are above financial reversals?

Mr. CRONK. Absolutely not.

Chairman BAKER. OK. Thank you.

In your written testimony—I know these are not necessarily your particular work product but that of the organization—the realtors make reference to systemic risk management, and the point being that OFHEO stress test would be the appropriate remedy to analysis of systemic risk potential.

Do you know if any of the experts who may have provided your information have looked at either their default models that are contained in that stress test calculation, counter-party risk analysis, or interest rate modeling requirements, specifically the weighting of risk of derivatives versus debt instruments, for example? Has that been something the realtors have engaged in a discussion on?

Mr. CRONK. We met with OFHEO and we have provided comments relative to those risk-based capital standards.

Chairman BAKER. But you have not been familiar with those particular provisions of the stress test?

Mr. CRONK. Our staff has studied them, but we haven't got into them in complete depth.

Chairman BAKER. I would think not.

In your meeting with Mr. Kinsey, did you talk about the test being a predictor of probability of failure rather than being a predictor of severity of the risk?

The reason why I ask that question to help you. In speaking with Mr. Kinsey yesterday and asking what is the effect of the stress test from your regulator's perspective, it is to determine the probability of failure, not to determine whether systemic risk potential exists, which goes to the extent or severity of the financial reversal, the point being the regulator has told me that that stress model is not a calculator nor a predictor of systemic risk to our economy. It is, rather, a predictor of whether the enterprise is likely to have difficulty, the point being the organization has recommended that is an appropriate step to take for insulation against systemic risks. The regulator is telling me it won't work.

I would hope those who provided you with this information would perhaps review it again.

From the standpoint of probability of failure, Mr. Smith, I understand the home builders have taken the view that there is not like-

ly to be a business cycle in which housing demand softens and interest rates go up?

Mr. SMITH. No, they have not taken that view.

Chairman BAKER. But you believe that if that were to occur the world would be OK and we need not evaluate the underlying fundamentals of the GSE?

Mr. SMITH. I think you always need to evaluate the underlying fundamentals of GSE. It is critically important that they remain sound. There will be different markets. We know there will be. History has provided that and in the future we will see it again.

Chairman BAKER. My point being my whole motivation in this process has been to insulate against systemic risk. If you are acknowledging the potential for reversals of business cycles would occur, what recommendations are the home builders making in order to insulate us against a systemic risk potential from the GSEs?

Mr. SMITH. Well, we think that there are in place the OFHEO, their risk analysis, their recent report to the Congress. And when you use—when we discussed stress tests as part of a risk analysis, we have watched the performance of the GSEs under the ultimate stress test, which was the reversals in the economy in the late 1980's and early 1990's. They did quite well, much better than other parts of the financial system.

When I say the GSEs, I mean Fannie Mae and Freddie Mac.

So, combined with understanding the history of a live stress test along with the ongoing work of OFHEO, we believe they are sound.

Chairman BAKER. I would expect you would say the experience from 1979 to 1984 when Fannie Mae was insolvent was just an aberrant activity that would never occur again?

Mr. SMITH. I believe that they have now—Congress, your Congress, has put into place the necessary oversight to be able to see that that does not occur.

Chairman BAKER. With a stress test which is not yet implemented.

Mr. SMITH. Yes, but it is there with OFHEO, and if they are able to enact and act on what the consensus of the Congress when they put OFHEO in in 1992 and the most recent changes, we believe it is there.

Chairman BAKER. The point is it was required in 1992. As we sit as participants in the hearing today it is not in effect. There is considerable debate among the market participants, the GSEs, as to the construct that is being put together and its appropriateness. We do not have a safety and soundness regulator today. This Congress debated at length increasing the funding of the OFHEO enterprise from $18.6 to $21 million just a few weeks ago—an effort which I supported, even taking to $25 million. If the enterprises were OCC regulated financial institutions based on asset size, their regulatory charge would be $67 million. There is a regulatory mismatch which is absolutely clear, without dispute. There is no regulatory oversight in effect as a result of the stress test, and the idea that the stress test could be used as an insulator of systemic risk is very difficult for me to accept.

I have exhausted my time.

Mr. Kanjorski.

Mr. KANJORSKI. Thank you, Mr. Chairman.

Let me ask an open question. Do any of you have an opinion that either Freddie Mac or Fannie Mae is now bordering on a risk in our society where essential action must be taken immediately to prevent systemic risk from occurring?

Mr. Bartlett.

Mr. BARTLETT. No. We think action is essential. We don't think it is—it is not something that has to happen tomorrow. We don't see any kind of imminent failure or anything like that.

Our main focus is on the mission, Congressman. We think that the mission is way beyond what Congress had intended, and we think that is what you ought to focus on.

Mr. KANJORSKI. So, in accordance with Mr. Baker's previous questions, you are not worried about a safety and soundness problem. You think our system is rather secure, it is just a question that you represent an interest group that feels there is a little bit of trespassing may be occurring?

Mr. BARTLETT. Congressman, that isn't the way I would put it. I believe that the consumers are being misserved and would be more misserved in the future. I also think there is an underlying safety and soundness issue. You asked whether it was imminent. I don't think there is an imminent crisis.

I think over the long term a financial institution needs a regulator, and I don't believe that Fannie Mae and Freddie Mac have a regulator right now—a regulator that is empowered to regulate them.

Mr. KANJORSKI. Does anybody else have an opinion as to whether we have any real systemic risk at this point in time?

Mr. CRONK. From the realtors' perspective, obviously we have not seen and cannot see any evidence that there is a risk factor in place now, but I can appreciate and admire the subcommittee for their study of the process, because obviously we do not want a return of what has happened in our economy before in the savings and loan that somebody has referred to, but I think that we all—everybody would concur that Fannie Mae is about as solid today as we had all hoped for them to be and strong in the marketplace, and there is no reason not to prepare for the future, but things do happen. But I think we need to have a strong independent regulator in place and uniform risk-based capital standards I feel—and I think others feel—will be in place by the end of this year. Unfortunately, it has taken eight years to get them in place, but they are at the point right now that we hope that that will be successful and be sufficient to cover any potential risk that the Government may have in front of them.

Mr. KANJORSKI. Does anybody else want to comment?

Mr. BOCHNOWSKI. Mr. Kanjorski, this might be the time when we do not have pressure on the system to actually implement the study that would relieve pressures that exist somewhere down the road.

Mr. KANJORSKI. I absolutely agree we should study the issue, but we are talking about legislation right now. We are talking about potentially imminent legislation.

Mr. BOCHNOWSKI. I do not think that there is an imminent risk that exists at the moment, but the pressures might come that if they are evident at some point in the future.

Mr. KANJORSKI. So, as I understand it, your indication is we have the time to study this issue and we should take the time to study it and the subcommittee is taking the right action.

Mr. BOCHNOWSKI. And act, and provide a strong regulator.

Mr. KANJORSKI. Yes. Very good.

We had a hearing yesterday on the reauthorization of the Commodities Exchange Act, where we discussed the growth and potential risk of the derivatives market, which is now about an $80 trillion market. Interestingly enough, commodities exchanges are regulated by the Commodities Exchange Act which comes out of the Agriculture Committee, which is an interesting take on things.

But the question was whether or not we are capable of defining futures and distinguishing what futures and swaps are, and a working panel concluded that it was beyond the realm of humankind to define what these products are.

Relating that back now to products in real estate, I am a little disturbed that we are trying to define future products. I would like your opinion as to whether or not it is a mistake to set parameters. Do you see an evolutionary or revolutionary process occurring in the real estate market, where new products are being conceived of and implemented to the advantage of the market? Should we try and define exactly what these entities can deal with, whether that will be too constrictive, and should we give a lot of discretion to whomever we select as the regulator to have discretionary authority to watch the system and allow products to evolve?

Mr. SMITH. It is a revolution. There was no question, as my children often say to me, "Dad, this country and this entire financial system is going at warp speed."

The needs are definitely there. We are existing in an obviously extraordinarily successful environment financially, and yet 40 to 50 percent home ownership rate for blacks and other minorities and Hispanics is just not acceptable.

You have to allow a market to be able to move quickly in this world and move fast in order to satisfy the needs. An overburden of a regulatory effort on the natural market forces has never, ever worked. You need, obviously, to have regulation to keep GSEs and other financial institutions within their charters and to be safe and to be sound, but if they cannot move in a market and you try and overlay a marketplace, it will create great disinformation and we will stifle the very thing that has made this the greatest housing country in the world.

Mr. KANJORSKI. Anyone else?

Mr. BARTLETT. Congressman, quickly, greater competition—that is, competition from hundreds of providers instead of just two—will create better innovation, more innovation, more products, and better products for consumers, and that is the underlying purpose of this bill is to allow greater competition rather than less competition.

Mr. KANJORSKI. Do you think we should have a licensing process for other secondary private market participants?

Mr. BARTLETT. The two GSEs, or the GSEs have a Federal charter, and that Federal charter provides implicit guarantees and benefits. We think that those benefits ought to accrue only for the purpose of home ownership or residential home mortgage market, which is a stated policy of the Congress, and not for all the other things, and we think even that needs a regulator.

So this bill does safety and soundness with a regulator and also says that the purpose of the Federal implicit guarantee is for home ownership and not for other purposes.

We think then that opens the rest of the market up for much greater innovation because it will have greater competition.

Mr. KANJORSKI. My time has expired, Mr. Chairman.

Chairman BAKER. Thank you, Ms. Kanjorski.

Mrs. Biggert.

Mrs. BIGGERT. Thank you, Mr. Chairman.

Mr. Bartlett, regarding the new activities, you suggested that the bill's approach should be simplified. Do you have any suggestions?

Mr. BARTLETT. Congresswoman, we do, and we will work with the staff on specifics.

We like the approach, and that is to have a sole regulator that does both safety and soundness as well as mission. The GSEs and—I would have put this in the bill in 1983, had we realized the explosion of the mission—the GSEs have no one to go to right now effectively. There is no arbitrator, so we think this—I am sorry, HUD tries to be an arbitrator. We think this strengthens the arbitration by determining what is in the mission and what is outside the mission.

We think it can be simplified. We think that it doesn't have to be every tweak of the original product, but we think that a sole regulator with both mission and safety and soundness can create that bright line.

So we will work with you on some ways to simplify it, but we think that a determination of that mission by the regulator is overdue.

Mrs. BIGGERT. OK.

Mr. Cronk, in your testimony you mentioned the realtors' objection to the GSEs' expansion into property disposition activities, including bidding on third-party foreclosures.

Mr. CRONK. Yes.

Mrs. BIGGERT. Do you believe that this bill's provisions regarding new activities might have helped in this regard, the way that the bill is written now?

Mr. CRONK. It may, as was written, but it is not necessary because we have been able to sit down and have dialogue and work through these issues that we disagree on, and we have been successful in the past and feel confident we will be successful on this one.

Mrs. BIGGERT. OK. Thanks.

And then, Mr. Bochnowski, you talked about repeal of the Treasury line of credit and you don't agree with that. Could you expand a little bit more, since this has never been used by anyone, and yet it is there?

Mr. BOCHNOWSKI. The line of credit, while it has never been used, is a symbol, and the symbolism is one that suggests that

Fannie Mae and Freddie Mac have access to low-cost funds. That assists in driving down the price of housing as far as the affordability of housing and affordability of loans. And so I think our concern would be the unintended consequences that was raised a little earlier.

If that is removed it might be disruptive in the marketplace as far as Fannie Mae and Freddie Mac stock is concerned. I think it would be far more disruptive perhaps for the ordinary borrower and it would drive up their cost to finance.

Mrs. BIGGERT. We seem to have, where there is the policy, or what is public policy is: what are the GSEs to do at the behest of Congress? Are they really to provide housing as a major policy for—home ownership seems to be a major policy. Is there a balance between those two? And does this line of credit help with that or does it hinder it?

Mr. BOCHNOWSKI. It doesn't appear to be hurting it. It appears to be assisting it, simply because the availability creates, at least in the mind of the marketplace, the idea that funds are available, and should there be any difficulty, any stress within the system, that those stresses would be equalized by the line of credit.

Mrs. BIGGERT. Thank you.

And thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mrs. Biggert.

Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman.

I was just getting some clarification from staff.

It seems to me the dilemma that we face with this bill is, on the one hand, I think everybody endorses greater regulation or oversight of the GSEs. It is hard for anybody to be against that. We, of course, have OFHEO, which is working its way through a regulatory process, a rule-making process, and hopefully by the end of the year we will have risk policy rules for the GSEs and we will have an opportunity to look at that. Mr. Baker attempts to address part of that in his bill.

On the other hand, it seems to me that we have a situation where, as the marketplace has matured, other competitors are concerned that the GSEs—in particular, Fannie Mae and Freddie Mac—are much too powerful and, in particular, because of their ties to the Federal Treasury, and that somehow they ought to be reined in.

It seems to me—and I don't want to sound too much like a libertarian or anything like that, but it seems to me that that is an unworkable prospect, and I note with some interest an article that was in the *Wall Street Journal* on June 30th, which is similar to a line of questioning that I have raised in some earlier hearings that we have had—not quite similar, but it is along the same track—that a proposal apparently was floated out there, immediately denied by one of the GSEs, that perhaps they would at least spin off part of the GSE into a completely private, separate corporation from their structure now.

I raise this again for this panel, because I have tried to ask other panels about this. What would be your position if Congress said, rather than trying to just put a tight leash on the GSEs, which I think some would like us to do in order to artificially level the play-

ing field, if that is what they are trying to accomplish, instead we said it has worked so well that we have accomplished so much through a federally-sponsored secondary mortgage market that now has come the time for the children to go out on their own? And obviously we would have to pass some bills to do that, but what would be the position of your groups if we were to propose to do that?

Steve.

Mr. BARTLETT. Well, Congressman, at this point it is a brainstorm of Lou Renarian, and I have generally found Lou Renarian's brainstorms to be quite brilliant, but we would have to look at it a lot more carefully.

A couple of comments on it, though, and that is that one possibility for Congress at some point in the future, either with or without this splitting up, would be to create an open entrance charter—that is to say, the difficulty with this charter is not that it is a bad thing, but that it allows other activities, and the process of reining the other activities in, one could envision allowing other charters, just as with other kinds of financial services institutions, to obtain a GSE-like charter with sufficient regulation, and then you would create maximum competition, and that would sort of fit in nicely with the idea of the "split up."

I think it is way too early. I do think that, while one could make an argument that this is too large a problem in the current context, that for this subcommittee and then Congress to redefine and take a careful look at the mission, at the statutory mission, and then to create a sole regulator for both safety and soundness and mission definition would be a good first step. Whether that leads to other steps such as an open charter or multiple GSEs or not I think time will tell.

Mr. BENTSEN. If I can just follow up quickly—and I want to hear from the others—your point, Mr. Bartlett, is that we go part of the way on the regulatory side, but perhaps not go so far as looking at issues like line of credit and things like that. Let us get a handle on the oversight.

I think that is something that this subcommittee might be receptive to. I also think we have to look closely at this issue of, in effect, putting Fannie and Freddie under the Administrative Procedures Act or some hybrid thereof. I am not sure that we would want to go that far, but perhaps more oversight in the new product.

I don't know if anyone else has a comment or not.

Mr. SUMNER. I have a more simplistic approach. I think that the regulatory oversight issue is one that, as you have heard today, is of concern because I think the regulatory process really—I mean, for an entity that was created eight years ago to come up with capital standards and still doesn't have it, something is dramatically wrong. I mean, it is not that complicated.

Congressman Kanjorski, you mentioned the derivatives market and the complexity of that. We clearly are in a marketplace that has dramatically changed from where it was ten years ago, but I think it really asks the question of a stronger regulatory oversight here, and I think that the public deserves that sort of a response.

So I think, in one sense, H.R. 3703 is right on target in that regard, I think the repeal of the line of credit that they have would really—I mean, we have a system that is working. The secondary market and the purpose for which Fannie and Freddie were created is working in providing liquidity for the secondary market.

I don't think anyone will dispute that, but I think that there are other elements here at work that go beyond what that is, but it doesn't make sense to—I think if something is not broken, to try to go and fix it and get into issues of, like, privatization or whatever, that is going to take a lot of study, and there have been a lot of people, as we all know, who have opined on what that may or may not bring to home ownership.

But I think home ownership is working with the liquidity that the GSEs provide, but the competitive area on the primary side is something that needs to be looked at, as well, and this blue ribbon panel that we have convened, with Fannie Mae and Freddie Mac, hopefully will result in a real definition of what is primary and secondary that would help, I think, respond to your question.

Mr. BENTSEN. Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Bentsen.

And should it be necessary, although I don't think it will be, if anyone accuses you of being a libertarian I will come immediately to your defense.

[Laughter.]

Chairman BAKER. Mr. Cook, you were next by arrival time.

Mr. COOK. Thank you, Mr. Chairman.

I want to commend this panel. I have learned from your testimony and I particularly want to acknowledge Kit Sumner from my home town, who is CEO of the CrossLand Mortgage Corporation there in Salt Lake City, and President of the Mortgage Bankers Association of America.

I would like to start by just asking you, Mr. Sumner, if you think H.R. 3703, in just overall terms, is in the best interest of the American homeowner or not?

Mr. SUMNER. I think the Mortgage Bankers Association is certainly supportive of H.R. 3703, with the exception of this line of credit issue. I think that there are some huge ramifications to a change of what that really means without a lot of thoughtful study. I think, again, the secondary market, as I just mentioned, works as far as the GSEs providing liquidity for that marketplace, and that is what their role is and that is what they have done an excellent job in doing.

But, as far as the regulatory side of this, you know, again I think it is—I don't think—I think if something were to happen, as has been stated, I think we would all certainly suffer the consequences of the fact that there really hasn't been any regulatory review here, and that needs to be done without question.

Mr. COOK. I wanted to ask Mr. Cronk, I noticed in your written testimony that you oppose repealing the Treasury line of credit for the GSEs, but you didn't say that in your oral testimony. I just wanted to make sure or clarify that is your position, that you oppose the provisions of H.R. 3703 that would repeal the line of credit; is that correct?

Mr. CRONK. Yes. I tried to make it clear. There was really only one part of it that we really feel we could support at that time, and that is, of course, the strong independent regulator.

If I may just expand upon that?

Mr. COOK. Sure.

Mr. CRONK. We are very much concerned about tampering with something that just has worked so well and American home owners have benefited so greatly from, and there are four things that I attribute to the bill, to the GSEs that they are giving to this marketplace, and the charters allow that—stability, liquidity, efficiency, and, above all, affordability for American home owners.

Mr. COOK. OK. I think I am clear on what each of the witnesses are saying, I think, in terms of the regulator and in terms of the line of credit, but I would like to just explore any of your feelings on revisions of the appeals process and new products and so forth. I would like to—maybe with Mr. Bartlett, I want to be sure I understand exactly what you are saying in terms of that.

I take it you think that is probably as big an issue as even the regulator issue?

Mr. BARTLETT. It is equal, Congressman. We support the review of the new products. We think that it could be simplified, the review could be simplified and streamlined, and we think that the review should have some kind of a safe harbor so that if a lender comes out with a new product or with a slight tweak on the old product that it wouldn't require cumbersome review. We think all of that is easily workable in the legislative language.

But a review of the new products and new activities is essential by the sole regulator, who is also doing safety and soundness. We think that is a key part of this bill.

Mr. COOK. And then finally, Mr. Sumner, I take it you sort of agree with that. Is there anything you would like to add or not agree on?

Mr. SUMNER. I agree with Mr. Bartlett. I think time to market is important, and how that can be done appropriately should also be factored in, but I think product review is certainly important, so long as, again, it is the role of the regulator in ensuring that the secondary market activity is followed through on the part of the GSEs.

Mr. COOK. Thank you.

Chairman BAKER. Thank you, Mr. Cook.

Ms. Waters.

Ms. WATERS. Thank you very much, Mr. Chairman. I was just trying to do an assessment of all of these hearings we have had, these five hearings or so, to see what we have learned and to see if there is any consensus that is forming, and I am not so sure there is.

I want to just recap something to make sure I understand where some of our witnesses are today as it relates to the repeal of the so-called "Treasury lines of credit" available, even those that have not been used by Fannie Mae and Freddie Mac.

Am I to understand that there is opposition to this from several of those who are here today? Let me just find out.

Home builders, Mr. Smith, am I to understand that you oppose the provision that would repeal the Treasury line of credit?

Mr. SMITH. Yes.

Ms. WATERS. Mr. Cronk with the realtors, do you also oppose Mr. Baker's proposal to repeal the Treasury line of credit?

Mr. CRONK. Yes.

Ms. WATERS. Mr. Sumner with the Mortgage Bankers—I think I just heard you, and you sounded as if you definitely oppose the proposal to repeal the Treasury line of credit; is that true?

Mr. SUMNER. Yes.

Ms. WATERS. OK. And Mr. Bochnowski, America's Community Builders.

Mr. BOCHNOWSKI. America's Community Bankers, yes, we do.

Ms. WATERS. Do you also oppose Mr. Baker's proposal to repeal the Treasury line of credit?

Mr. BOCHNOWSKI. Yes, we do.

Ms. WATERS. So I guess we almost do have a consensus on something here.

Now, I also understand that, Mr. Chairman, we have had some representation from the National Bankers Association, the American League of Financial Institutions, and the National Association of Real Estate Brokers, who may not be represented here today, but they also oppose your bill as it relates to the repeal of the Treasury lines of credit.

Is that your understanding, Mr. Chairman?

Chairman BAKER. I think the only group you left out is the Treasury Department, which does support it. Thank you.

Ms. WATERS. Well, I want to make sure that we are all on the same track here. I do have some communication from those groups that I just mentioned, and I would like unanimous consent to put that into the record.

Chairman BAKER. Without objection.

Ms. WATERS. Without objection, is that OK? All right. Thank you very much.

I would like to apologize for not being able to be here earlier to hear some of the testimony, and I don't think I have any questions beyond those that I have asked except for you, Mr. Chairman. How many more of these hearings are we going to have?

Chairman BAKER. Well, there seems to be a deep need for additional information to make this important decision, and I certainly don't want to disappoint Members of the subcommittee and cut off the debate and have a vote before we are all fully informed, so I would expect this would go on for quite some time.

Thank you, Ms. Waters.

Ms. WATERS. All right. Mr. Chairman, let me just say that I think that my colleague indicated that not only is he opposed to perhaps additional hearings, but asked of you if you planned on trying to take this up for markup this year. May I inquire also?

Chairman BAKER. Certainly. Yes, ma'am. It would be my intent, once we have reached consensus, which you have aptly described we are getting close to, that we would certainly consider markup.

Ms. WATERS. You would consider markup this year?

Chairman BAKER. If we are able to reach consensus. Yes.

Ms. WATERS. Thank you very much, Mr. Chairman.

Chairman BAKER. Thank you, Ms. Waters.

Mr. Royce.

Mr. ROYCE. Thank you, Mr. Chairman. I want to begin by thanking Mr. Cronk and Mr. Smith and the other panelists for their testimony today. I want to just make the observation that in my view the best policy would be to completely privatize all three of the housing GSEs—Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System—and by "completely privatize" I mean eliminate any tie to the Federal Government such as the line of credit and any form of housing goals or mandates from Washington.

I think, while many of my colleagues would agree with eliminating the advantages that the GSE enjoy as a result their quasi-governmental status, very few support eliminating the housing mandates that the GSEs are subject to as a result of that status.

One of the observations I would make—and I would like your comment on it—is that I do think we have had a number of constructive points that have come out as a result of these hearings.

I am concerned that an entity I consider problematic, the Federal Home Loan Bank System and the Mortgage Partnership Finance Program, seems to have been dropped from the focus of this bill and from the focus of this subcommittee.

I would like to just quote from an article in *Baron's* not long ago—and I have written a number of letters to the Chairman and I have written a number of letters to the Federal Home Loan Bank System on this—but, just to quote from that article: "The Home Loan Banks have a new program dubbed 'mortgage partnerships finance,' which enables them to offer lenders a far better price for the loans than almost anyone else. The Home Loan Banks have exploited every tax funding and capital advantage they possess by virtue of their Congressional charter."

But it goes on to explain that the purchases have been kept in check by a cap. Now that cap has been lifted. And here is the down side—the down side is the risk.

The risk is, according to the article, that the loan is never on the balance sheet of the lender, which means that all of the interest rate and prepayment risk belongs to the Federal Home Loan Bank. Indirectly, that risk belongs to the taxpayer.

The banks are skimping on interest rate hedges on their loans to fatten their bottom lines. Each bank decides how much risk it wants to take. Critics say the banks are leaving two-thirds of the loans unhedged on the assumption that they will be paid off in five to ten years, and they don't mark their portfolios to market. That is another observation.

So the risk there of a program where the cap has been lifted is, in my view, going to be borne by the taxpayers. As I say, in this debate this issue is being side-stepped, in my view.

One of the questions I have is, as we talk about building consensus, do you believe, Mr. Cronk or Mr. Smith, that consensus has been reached on this legislation? And do you support moving forward to a markup of this legislation?

Mr. CRONK. I don't think we can support moving it up in its present form. I think there are some things that are positive about it. I think it needs additional work.

When you relate the Federal Home Loan Bank Board, it is difficult for us to relate to it, because their activities really in the home mortgage business has been somewhat limited, and Fannie

Mae and Freddie Mac have really been the stronghold in the secondary mortgage market.

But in its present form we would have difficulty supporting it in a markup; however, I am sure there are good parts of it that maybe we can find a way to support.

Mr. SMITH. No, I don't believe there is consensus, and we do not believe that it should move to markup. We believe that it should move to additional dialogue for constructive dialogue and discussions on all facets of the bill where we can cooperate and hopefully be able to add to the debate, but at this point shortcutting that and going straight to markup I don't think would serve either the purpose of the bill or the housing community in America.

Mr. ROYCE. Thank you.

Thank you, Mr. Chairman.

Chairman BAKER. Thank you very much, Mr. Royce.

To respond briefly to the comments concerning the Federal Home Loan Bank System, it is not off the radar screen. Some merely have suggested that the turmoil I created last year in that arena might need to subside before more turmoil is created, but I share your views with regard to appropriate regulatory oversight, mitigating taxpayer exposure, and absolutely commit to be responsive to those concerns.

Mr. Cronk, you indicated that, in response to a question from Ms. Biggert, that the Southern California Realtors' problem had been resolved?

Mr. CRONK. No. I said that we are having dialogue now and we feel confident that we will resolve it.

Chairman BAKER. Well, just for the record, these are unsolicited. I would like to give you copies of the Southern California Realtors letters we have gotten over the past few days since they finally found our subcommittee. They appear to have a slightly differing view on the matter.

Mr. Smith, I believe you said that there might be some elements—or maybe it was Mr. Cronk, as well—there were some elements of the bill you might be able to support. Could you illuminate the subcommittee? What is it that you found in the mark that is something worthy of support? I missed that in your testimony. Is it the line "Baker-Kanjorski"?

[Laughter.]

Mr. SMITH. As I have stated before, the objective of going toward a single regulator, creating greater efficiencies in the system is to be applauded, and we do support that.

Chairman BAKER. Do you have a suggested regulator?

Mr. SMITH. No, I do not have a suggestion. That was part of the dialogue at this time, because we haven't been asked if there is a different regulator other than what has been suggested in the bill. We think that the regulator format that is suggested in the bill is cumbersome and overlapping in many agencies and probably wouldn't serve the process best, but we would like to engage in the dialogue of that and come back to you with our suggestions.

Chairman BAKER. Let me suggest, if you could, Mr. Cronk, Mr. Smith, before we reconvene in September, if you could give me your written recommendations it would be most helpful. Today I under-

stand your criticisms very thoroughly, but sometimes light is more important than thunder, if you know what I mean.

Mr. Cronk.

Mr. CRONK. Thank you, and I appreciate that, and we most definitely will. We do believe in a strong, independent regulator, and, you know, privatizing Fannie Mae gives us cold chills. We don't want that to happen, because we think the success today is because you guys created them and they are what they are.

So a strong independent regulator, we would be more than happy to work with you on that. We don't think that the methodology that is developed in the bill right now is one that will work, because we do want them to allow them to be efficient and creative and create that stability in the marketplace.

Chairman BAKER. With regard to one other point in your testimony, you indicated grave concern what the market would appear like if there were no GSEs in existence, so let me make it clear for the record. I have not even said the word "private" much less "privatization." This is about seeking to mitigate systemic risk potential.

The construct of the regulatory panel is based upon discussions with regulators. It is a logical place to go if you are trying to build a model to ask people who do it. However, having said that, nothing in this bill is in concrete and final form. The purpose of the hearings is to receive constructive recommendations about how to improve it. I would note for the record we have not received those helpful comments from the GSEs yet, either.

With regard to the debate on the CEA reauthorization yesterday, Mr. Kanjorski makes a very good point. The markets are moving rather rapidly. For example, Mr. Kanjorski, just last month there was a new futures product created on the Fannie and Freddie ten-year note. Under the rule as it currently is constructed, since they are on exchange traded securities, they will be regulated by the CFTC. Just for the record, I make a point, our regulatory structure is not adequately prepared to deal with the diversity of these GSEs and their scope of business enterprise. I think it highly important that this subcommittee, in our consideration of that issue in the coming days, discuss the consequences of the current regulatory structure on the development of financial product.

Let me not be remiss in saying to Mr. Bartlett, Mr. Sumner, and Mr. Bochnowski I have somewhat been focused on the other participants' remarks. I do appreciate your constructive criticisms of the bill and would like to point out the line of credit question has been subject to some discussion. I would like to get your concept about this proposal.

Currently Freddie Mac engages a rating agency annually and makes the determination based upon that rating whether or not employees should receive bonuses. I found that interesting.

I have also discussed with Mr. Rains the idea of a conditional line of credit being available, the idea being we want to backstop before credit quality erodes from AA, AAA, whatever they claim they are today—I am sure it is wonderful—before you get to the taxpayers' front door—early intervention by market discipline, to make investors market utilizers of the product that there is potentially a problem. That is it.

Now, what I suggested was, subsequent to an annual rating—and we set a floor, and if you fall below that the Treasury ability to buy securities is suspended until you return your credit quality to an appropriate level, far before insolvency.

This is very similar in concept to what we do with the early intervention statute now for national banks.

Do you still have the same feelings about that approach to a line of credit? I would be happy to hear anybody who wants to talk about it.

Mr. BARTLETT. Congressman, we didn't take a position in the formal testimony on the $2.5 billion direct line with the Treasury. We would support its removal at the appropriate time, but we didn't take a position, because—and I only say it now because it is probably the least-important of all the things here. The $2.5 billion line is a trip-wire against $3 trillion of mortgage-backed securities, so if you ever get to that line then you are going to go way over it, so it is only a trip-wire.

I think that your proposal in this bill of the sole regulator but also of the two rating agencies is a far better trip-wire, at which point the line—we don't believe that the line of credit is needed today. It helps to strengthen that implicit guarantee, and I think that is what Congress wants to get away from, so in that sense——

Chairman BAKER. Even the GSEs have admitted it is a marketing tool.

Mr. BARTLETT. It is part of the implicit guarantee. I think Congress probably wants to get away from the implicit guarantee, so removing it would help you in that. But it is not important. If you have to use that credit, then the party is over. Using these two rating agencies is a far better way to do it and would make a line of credit totally irrelevant.

Chairman BAKER. Any other comment?

Mr. SUMNER. My concern with the concept of a trip-wire would be to look at the banking side and draw an analogy to how they are regulated and the CAMEL ratings that banks have, and if a bank has a poor rating then that has regulatory consequences.

I think a process such as that would make a lot of sense, as opposed to maybe something that the market may, in fact, discount right out of the box by knowing that, in a worst-case scenario or in a bad case scenario, that that line would not be there, and therefore it would be tantamount to a revocation of that line when, in fact, that really wasn't what was intended.

Chairman BAKER. That is something else we have looked at is a regulatory requirement to have something similar in concept to a CAMELS rating, so when you move to a two to a three bells and whistles start going off.

I am just looking for a solution to the problem, and if anybody has got one I would be happy to hear it.

Mr. BOCHNOWSKI. I think our concern—it is worthy of study and we would be happy to work with you on it, Mr. Chairman, but our concern is that, in difficult times if the line of credit is pulled then that might create the very disruptions that we are trying to avoid.

Chairman BAKER. But a $2.5 billion line of credit is absolutely nothing. Foreign central banks hold $68 billion of this security. What are we thinking?

Mr. BOCHNOWSKI. I would agree with you.

Chairman BAKER. Anybody else have a comment? I am a bit over my time, but does anybody else wish to make a comment on that?

Mr. BOCHNOWSKI. Both agencies have probably issued $2.5 billion while you were asking this question.

Chairman BAKER. About a week. It is not even a week's worth of trading.

Mr. Kanjorski.

Mr. KANJORSKI. Mr. Chairman, let me try and reconstruct where we are, as I talked about in my opening statement, and where we are going.

First of all, and to use a phrase that is very common in the political structure today, I think you have a good heart and in your heart you want to do good.

Chairman BAKER. Oh, I needed that more than you know. Thank you, Paul.

[Laughter.]

Mr. KANJORSKI. And I would like to compliment the panel. I think this has probably been one of the most productive panels insofar as they have not come with an extreme personal interest here to defend or attack the secondary market. I think that is very helpful.

I think we have a common understanding here that we all would like to look at the best type of regulation and what the strength of the regulator has to be to make sure that in good times we anticipate what could happen if the economy turns sour and we need support systems.

I would like to voice some of my opinions on these issues. The line of credit is not a huge factor, but it is a signal to the marketplace. It is dangerous, extremely dangerous to tinker with it and send a message out there to the marketplace that we do not have to send. But I just want to call everybody's attention to the peso default in Mexico a number of years ago and the need for fast intervention. Some of us in Congress, including myself, questioned whether the way the intervention was made and the tools that were used were proper, and whether it should have been taken.

I think that we had a consensus that Congress was incapable of acting at that point in the emergency. What would have happened if prevention and support systems were not taken by the Federal Reserve, the Treasury Department and other elements of the United States Government to support the peso and straighten out the Mexican disaster? I think that is what that line of credit does. It gives you the assurance that when everything else is gone you can still keep things afloat to have time to put a response together. I do not know that we want to send a message that we are going to strangle that potential. I do not know why it is healthy to do that. Certainly $2.25 billion is not a big risk to the Federal Treasury if it were put to good use, or if it were spent unwisely. That is not going to be our problem.

I guess this panel has been informative to me, anyway, and Mr. Baker and I have been discussing now over a matter of months this whole idea.

The expertise on these questions does not reside on this side of the bar. I will be the first to admit that. Sometimes the people in the financial world and the complicated transactions they engage in absolutely mystify me. But I think we probably have to look further and this is a good time to look further.

Mr. Sumner, you mentioned that you have a task force or a working group put together. That is admirable. That is very helpful to us. I am just wondering whether or not we should encourage a little further down that path, either in a formal or informal method, of using that as a basis as the beginning of a roundtable.

We have not seen the attack process on this panel today as we have seen on other panels. There are some people that really want to vent against these entities, and I understand that. But, it is not very fruitful to us. Whereas if we were to put ourselves in a room and have some honest dialogue about what is necessary, we could go far by finding out why some institutions think we should not go there or why they need some flexibility or discretion. I think, Mr. Chairman, in our discussion going over the vote we both admitted it would be very helpful. This may be an opportunity to take September, October, November, and January to talk about these issues and to have task forces come back with what should that regulator look like, how would we expect that regulator to act, and what kind of discretionary authority the regulator should have.

You and I probably agree on keeping Government regulators as far out of the private market and products as possible. If we try and define OSEs too tightly, we are going to strain the securities market in real estate. I think that would be an unintended consequence of gigantic negative proportions to the American economy.

I understand where the opposition is coming from and they have a right to say, "Hey, we want to know where the goalposts are and where the in- and out-of-bounds lines are." We have an opportunity to structure a regulator that can have discretionary authority to approach that issue for the protection of safety and soundness and for maintaining a fair and level playing field, which we all want to have. But I do not think we can do it from just this side of the table. I think we have to get into the industries. We need to make sure that we listen to the testimony of people who are out there every day that are causing this great economy to go on and not put a poison pill—an unintended poison pill out there in a piece of legislation or even the fainting of a poison pill. That could be very disruptive to the market.

So again, Mr. Chairman——

Chairman BAKER. Let me follow on to your remarks, Mr. Kanjorski.

Mr. KANJORSKI. Sure.

Chairman BAKER. First, for your kind comment, but second I would suggest we proceed accordingly: let's formally ask all the participants here today—this is July 20th—to have for our mutual subcommittee Members' benefit by August 20, during the recess, a report back to this subcommittee on each element of H.R. 3703, where you have differences suggest alternative recommendations, whatever they might be. The world is wide open. If you want to write back and say "Everything is just ducky, do not touch it," that

is fine, too, but let's have a formal response from each of the program participants.

And I would like to include in this request, Mr. Kanjorski, as I think as a measure of good faith, Fannie Mae and Freddie Mac and the Home Loan Bank. I am sure there is somebody in this audience that might have an interest in those organizations who could relay this message, if they are not directly available. Have all of them and then I will commit to you that, upon our return in September, we will engage in a small meeting, a policy discussion of the recommendations that are formulated and sent back to us. I have no objection to a real policy discussion on the issues and doing it in a manner which I think might be productive.

Please respond.

Mr. KANJORSKI. My response would be that I think we have heard several people comment that perhaps what is included in H.R. 3703 is enough to be in three bills. Maybe we ought to take it out of the context of the bill, itself, and break it into the issues.

I think we are going to come to a relatively good conclusion on the regulator.

Chairman BAKER. I just say use that as a framework. If you want to deviate from it, deviate from it.

Mr. KANJORSKI. If we could break those issues out and have them address those issues so that if we see no convergence of good feeling on any parts we can just lay those aside, because they are just going to take too long. But we may find that we have some consensus in the regulatory area that we could really work on and get some productivity out of it.

Second, I am struggling with the problem. I have called for the roundtable discussions and I am struggling with the idea of "Star Chambers." I think daylight on a public issue of this proportion is important, yet I know it has impact on the market when people can hear it, but I think we have to do it in the nature of a roundtable.

I know it is easier in Government to operate without the press and the public available, but it is their legislation, it is not ours.

Chairman BAKER. What I am not suggesting is a cloakroom get-together late one evening. What I am talking about is a thorough reading of everyone's interest. This is an open invitation, anybody in the office. If you are with Krispy Kreme and you have got an opinion, fine, send it. We want anybody who wants to comment get it to us by August 20th. We will review it carefully, privately. We will convene some sort of mechanism to then discuss what is contained in the information.

I think we ought to have a working meeting to enable Members to ask real questions and then have a public meeting.

Mr. KANJORSKI. I agree. Let me do this. Let us make it August 30th, because that gives us another week for us to review these responses, and we are certainly not going to have a hearing before September 15th.

Mr. BENTSEN. Will my wise colleague from Pennsylvania yield?

Mr. KANJORSKI. All the time.

Chairman BAKER. Your slow partner from Louisiana will get in here, too.

Mr. BENTSEN. I suggest we have two additional minutes. I just want to make three comments.

First of all, in your last comment, I would certainly hope that the Chairman and the Ranking Member would not mean that the panel would reconvene either on August 20th or August 30th.

Second of all, for the benefit of our constituency out here, second of all, I would hope that my colleague from Pennsylvania, when talking about the Mexican peso default, was not in any way inferring that this panel might look at the exchange stabilization fund as a potential line of credit for the GSEs.

[Laughter.]

Mr. BENTSEN. Third, I just want to remind my fellow Texan and dear friend, Mr. Bartlett, with respect to the line of credit and the fact that it may be small, I want to remind him of the many discussions we had with Chairman Greenspan on the question of operating subsidies versus a holding company model and the idea of an explicit versus implicit subsidy. Of course, Mr. Greenspan believes there are subsidies throughout the economy, and, while the $2.25 billion line of credit may seem small, it does, in fact, I think, provide quite a—the market interprets it as quite an implicit guarantee and subsidy, and I think, based upon the hearing that we had, the initial hearing we had with Assistant Secretary of Treasury Gensler, that we saw some market reaction, some not-nominal market reaction, because of comments regarding the line of credit.

So I think, from this Member's view, I think it is a bigger item than that, and we certainly should look at it, but I do not think we should dismiss it out of hand based upon its size. I think it has much more leverage to its dollar amount.

I thank the gentleman for yielding.

Chairman BAKER. Certainly.

Mr. Maloney.

Mr. MALONEY. No questions.

Chairman BAKER. Mrs. Jones.

Mrs. JONES. I would like to apologize to the panel. I was here and then I had to go testify before the Judiciary Committee, and I thought I would be five minutes and ended up being an hour-and-a-half. Maybe it was because I was interesting or something. I am not sure what caused the questioning to be so long.

I would have liked to have asked you a number of questions. Unfortunately, time will not allow it. But what I would say is I am very much a supporter of GSEs, and I think it is very important that we understand the impact that they have had in the housing market in our country, and when something is wrong I suggest that we—I mean, when you have a dilemma about an agency or a department or whatever, you do not blow it up and then try and fix it.

I am pleased to hear that Mr. Kanjorski, who was here, heard that this was one of the panels where people were reasonable and reasoned and had basis in fact for the statements that they made.

I look forward to the roundtable. I hope that somebody else will not ask me to testify, that I will have an opportunity to be here.

But, seeing how I do have five minutes, I want to plant something else on each of your laps as we are talking about housing in our communities, that is the whole issue of predatory lending. I know you are not here to discuss that today, but it is a significant

issue that is draining the wealth of low-income and minority communities across this country, and because you are in a position to be heard and to talk about issues and to have an impact on what happens in the financial community, I would ask you to do what you can to see that we relieve ourselves, even if we never get a piece of legislation passed. Morally it is appropriate that those of us that have the opportunity to be in this area need to do something about predatory lending.

I yield back the balance of my time.

Chairman BAKER. Mrs. Jones, I also made earlier comment on that subject in another hearing and share your view and have no reluctance to bring that matter into discussions of this issue.

Mr. Mascara.

Mr. MASCARA. Thank you Chairman Baker and Ranking Member Kanjorski for providing a continued examination into the role that the GSEs play in the housing market.

As I have stated in previous hearings, I am very appreciative of the contributions that Fannie Mae and Freddie Mac and the Federal Home Loan Bank System have made in providing liquidity in the mortgage market.

We are enjoying record rates of home ownership nationwide because of increased opportunities and lower cost to home buyers.

I have reviewed some of the testimony provided by our panelists today, and I am curious about the many concerns expressed about mission creep.

First, some of you—Mr. Bochnowski and Mr. Bartlett, in particular—have argued that the home equity loans now being offered by Fannie Mae and Freddie Mac exceed their mission; yet, they have been offering these loans since its inception.

What has changed in the marketplace that has prompted your opposition to this activity? And what remedies do you recommend?

Mr. BARTLETT. Congressman, I appreciate the question because, in fact, the home equity loan market has changed dramatically in the marketplace. I was in your seat, or at least on this panel, in the early 1980's when the Secondary Mortgage Market Act was written, which included second mortgages.

At that point, Congressman, I have to say that second mortgages were sort of well understood by those involved in drafting the legislation to assist someone to buy a home, a down payment, the extra 5 percent to make a down payment or that kind of thing, perhaps some repairs.

The home equity market today is a whole different animal. It has little to do, if anything, with home or with home ownership. It has a lot to do with other good things—college loans, debt consolidation, credit card loans—Fannie Mae at one point considered issuing credit cards tied to a universal account with home equity loans—new kitchens, other kinds of very good things. But those other things should not contain the Federal implicit guarantee.

I agree with the Congressman from Texas, Mr. Bentsen, when he said that that implicit guarantee is quite large and quite significant and it is quite powerful. It should not be used for other things other than home ownership.

So what has changed is that back then the second mortgage was a creature of home ownership and now it is not.

Mr. MASCARA. Ostensibly, then, those second mortgages were for remodeling of homes and other things other than buying boats and financing——

Mr. BARTLETT. At least at the time that we wrote the legislation. Of course, it is all mixed up and used for a lot of things, but by and large those were second mortgages and not what we now think of as the 1–800 call for a home equity loan, which is a new market, good market, but should not have an implicit guarantee.

Mr. BOCHNOWSKI. Congressman, the home equity lines are open-ended lines, and I would agree that what we are seeing is that this is financing of something other than housing finance, other than the purpose of getting into a home. The very fact that we are dealing with a second loan suggests that the borrower is already in the home.

Mr. MASCARA. My second question I have pertains to the GSE sales of foreclosed properties. Mr. Bartlett, I am particularly interested in your testimony in which you refer to a Freddie Mac store at a strip mall at which consumers may apply and pre-qualify for a loan, visit homes with their Freddie Mac counselor, have the home inspected, then purchase and close on the home.

Is this part of a joint venture, or is this exclusively a Freddie Mac operation? Is this loan origination?

Mr. BARTLETT. Congressman, I do not believe it is loan origination. I do not believe that loan origination is being offered by Freddie and Fannie. That is explicitly prohibited.

What this is is a home buying or sales and service without limitation. And we do not know where it is going. Most large national corporations do not put up one storefront except as a pilot program to go somewhere else.

I will be happy to make available to you the advertising information. What the advertising information says is it is a congressionally-chartered United States corporation, Home Steps; it is a real estate sales unit of Freddie Mac; it then says "Most home purchases require visiting several locations in different parts of town, a real estate office, a lending institution, an escrow company. At Home Steps, each of those things happen at our location."

It goes on to say, "You can preview all the homes"—all the homes, not Freddie Mac homes—"in your price range and their features."

It is an example of a clear expansion of the mission beyond providing liquidity in the secondary mortgage market.

Mr. MASCARA. I have run out of time, but I just wanted to state how dismayed I was and surprised to hear, after attending other subcommittee meetings about even the question of the solvency of Freddie Mac and Fannie Mae. Is there something changed since earlier this year when they stated unequivocally that they were in good financial shape, in fact made it through the 1980's and were a lot more solvent than some of the banks that were loaning the money?

Chairman BAKER. Would the gentleman yield?

Mr. MASCARA. Yes.

Chairman BAKER. I think something has changed. They were insolvent from 1979 to 1984 and now they are not. I think that is the big change. And we do not want to have that occur again.

Mr. MASCARA. But they are not solvent?

Chairman BAKER. Let me restate it. From 1979 to 1984, for a five-year period, Fannie Mae was insolvent. There was forbearance of income taxes due, there was regulatory forbearance, and they were allowed to grow their way out of the problem. No other savings and loan in the country had that opportunity.

My point is that they are well managed, well run, well financed. Heck, they had a 24 percent rate of return on equity. No corporation matches that. They are highly profitable. We just do not want to have a return of the prior unfortunate circumstance without adequate regulatory oversight, which we do not have, in my humble opinion.

Mrs. JONES. Mr. Chairman, if you would just allow me two minutes, I would ask unanimous consent for two minutes just to bring up the same issue, to follow on the same issue as my colleague.

Chairman BAKER. Go for it.

Mrs. JONES. I want to reference each of you who raised the issue of mission creep with regard to Fannie Mae and Freddie Mac to their charters, specifically Section 302.B.3, which says, "The corporation is authorized to purchase, service, sell, lend on the security of, or otherwise deal in loans or advances of credit for the purchase and installation of home improvements."

It also, in Section 302.B.5.a of the charter, says, "It is authorized to purchase, service, sell, lend on the security of, or otherwise deal in: one, conventional mortgages that are secured by a subordinate lien against a one-to-one for a family residence that is the principal residence of the mortgager."

And, as we talk about mission creep, it would just be good to go back to the charter. I think that these two sections specifically show that you can—Fannie Mae and Freddie Mac are authorized by charter to do home improvement loans.

Mr. BARTLETT. Congresswoman, if I could respond briefly.

Mrs. JONES. Please.

Mr. BARTLETT. Freddie and Fannie can make good legal or statutory arguments based on the statute, and they do make these arguments that each of their expansion of their activities is allowed by statute. Our response is two-fold. First of all, we ought to give the sole regulator, OFHEO, a clear and uncomplicated way to review that and to have that process so it is examined.

But second, and I think more importantly, is conceptually, Congresswoman, when you see ads in the paper that advertise—I believe from Ohio, actually: "Jennifer Crook was able to buy a new home because of Fannie Mae." Well, that is good, although she actually got the loan from a lender and then Fannie Mae bought the mortgage, but whatever it was, that was good, but that is not what you just described in those other sections of the mission.

So I think this subcommittee and Congress should reexamine the mission and determine whether, in fact, we want home equity loans, debt consolidation, new kitchens, and all of those other things included in the implicit guarantee.

I do not believe most Members of Congress and most members of the public can see that that is what they are after, but that is what is happening.

Mrs. JONES. I look forward to the roundtable discussion with you. We can further discuss it. Thank you.

Chairman BAKER. I just want to wrap up, if I may.

First, let me thank all the panelists and make a couple of observations.

One, I would encourage those who have not been to www.homesteps.com look at what is offered there. You can upgrade your carpet, your vinyl flooring. You can get a deal with Whirlpool Appliances. As a matter of fact, you might want to look under the asset management home page part of this, Mrs. Jones. Under the asset management part they even offer eviction services, which is kind of neat for somebody facilitating home ownership.

I just think there is a lot more than mission creep. I would call it "lurch."

And the closing line on one home page is "Coming soon, window shades." You know, I do not want to get off on that.

Congressman Hoekstra, subcommittee Chair of the Budget Committee, has announced hearings next week in the Budget Committee on related subjects relative to GSEs. I want to make it clear to Members that that will be occurring.

I am not sure I have got your date right, Mr. Kanjorski, but I would like to have an August 20th submission date from participants back to us to give us time to review the material before we return. Was that——

Mr. KANJORSKI. I just thought that was short.

Mrs. JONES. I think so, too.

Chairman BAKER. OK. August 30. We will give them ten more days. No excuse for anybody not making the deadline.

Number four, just an announcement. During the August recess—the Members may be aware that I asked Chairman Greenspan certain questions about GSE performance. He responded with an indication that it should be reevaluated in light of the $10 billion subsidy distorting the market. I will engage in a discussion with him over the recess to seek his counsel as to the best mechanism to prohibit that distortion from being a market factor. We will have a roundtable after receiving documents. We will have additional hearings when we return in September.

Everybody have a nice summer. See you soon.

[Whereupon, at 12:32 p.m., the hearing was adjourned.]

APPENDIX

June 15, 2000

CURRENCY

Subcommittee on Capital Markets, Securities and Government Sponsore Enterprises

Richard H. Baker, Chairman

For Immediate Release:
Thursday, June 15, 2000

Contact: Pat Cave (20
or Brookly McLaughlin (20

Opening Statement
Chairman Richard H. Baker
Hearing on H.R. 3703

The Subcommittee meets today for the third in a series of hearings on strengthening regulation and promoting market discipline of the housing GSEs. Hearings will continue this summer to ensure that every point of view is heard before the Subcommittee considers H.R. 3703, the "Housing Finance Regulatory Improvement Act."

So far we have heard from -- in testimony before this Subcommittee or in written comments -- the Treasury Department, Federal Reserve, housing GSE regulators and representatives from Fannie Mae, Freddie Mac and the Federal Home Loan Bank. Today, we will hear from two panels representing consumer and taxpayer interests. There is a great deal of talk about the effects of H.R. 3703 on the GSEs and their private sector competitors. It is important as well that we explore and understand the effects on the people not directly involved in the mortgage finance business.

The aim of this bill is to shield taxpayers from the potential risk the housing GSEs pose. I believe improved oversight of the GSEs will lead to more accurate market judgments, thereby ensuring a firewall between the GSEs and taxpayers. I think an improved oversight structure will aid consumers and lead to increased homeownership and more importantly contribute to more housing in minority and low and moderate income sectors.

I look forward to the concerns that will be addressed here today and all your comments on the bill.

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OPENING STATEMENT OF RANKING MEMBER PAUL E. KANJORSKI SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES, AND GOVERNMENT SPONSORED ENTERPRISES

HEARING ON H.R. 3703, THE HOUSING FINANCE REGULATORY IMPROVEMENT ACT

THURSDAY, JUNE 15, 2000

Mr. Chairman, thank you for the opportunity to speak before we begin our third hearing on H.R. 3703, the Housing Finance Regulatory Improvement Act. At our last hearings in March and May on this legislation, we heard from the present regulators for the housing government-sponsored enterprises or GSEs, the U.S. Department of the Treasury, and the GSEs affected by this bill.

During my opening remarks at those hearings, I noted that we should move forward cautiously in considering this bill so as to ensure that we maintain the delicate balance that has led to 67 percent of U.S. families owning their homes. I want to reiterate that viewpoint today. As we proceed in future weeks and months, we must renew our efforts to ensure that we do not accidentally raise homeownership costs. Although some have suggested that we should mark up H.R. 3703 later this year, from my perspective we should not move precipitously and attempt to legislate in the 106th Congress on this complex and important set of policy issues. We should, however, continue to use H.R. 3703 as a focus for our Subcommittee's oversight activities.

In order for our oversight to be effective, instructive, and objective we must ensure that our hearings are well crafted. Comprehensive hearings will help us to methodically debate the costs and benefits of H.R. 3703 and allow us to examine more thoroughly the many public policy issues related to the mission compliance achievement and safety and soundness regulation of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks.

During my opening remarks at our last two hearings, I have suggested that we convene a public roundtable discussion with representatives from all of the interested parties. I still believe that this forum is the most appropriate way for us to consider these issues. A roundtable would promote a free, fair, and vigorous deliberation by forcing the participants to challenge each other's assumptions and assertions in an open environment. It would also provide us with greater insights than testimony that has been vetted and sterilized through the clearance process. A roundtable would further allow us to more fully educate Members of our Subcommittee about the substantive issues involved in this debate and the real effects that this bill would have on our complex and successful housing finance system. I remain hopeful that as we proceed in the future with our oversight of the GSEs our Subcommittee will host a roundtable to understand more completely the need for and implications of this legislation.

Absent conducting such a roundtable today, we need to ensure that at each hearing our witness panels are balanced, containing a multiplicity of interest viewpoints and a broad representation of individuals. To improve the quality of today's proceedings, I would therefore request unanimous consent to submit for the record a number of letters that I have recently received from a number of community advocates and affordable housing groups.

In closing, Mr. Chairman, I look forward to hearing from each of our witnesses today. As we move forward with our oversight, I additionally hope that we will not only make a greater effort to consult with one another about the structure of, witnesses for, and content of future hearings, but that we will also work together to lower homeownership costs for all Americans.

LETTERS EXPRESSING CONCERN ABOUT H.R. 3703 FROM COMMUNITY ADVOCATES AND AFFORDABLE HOUSING GROUPS

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National Housing Groups

- AFL-CIO Investment Trust – Washington, DC
- Association of Local Housing Finance Agencies – Washington, DC
- National Fair Housing Alliance – Washington, DC
- National Housing Conference – Washington, DC

Community Housing Advocates

- A-HOUSE Program Alliance, Inc. – Atlanta, GA
- Asociacion de Puertorriqueños en Marcha, Inc. – Philadelphia, PA
- Bernal Heights Neighborhood Center – San Francisco, CA
- Buffalo Neighborhood Housing Services, Inc. – Buffalo, NY
- City Vision Ministries – Kansas City, KS
- Colorado Rural Housing Development Corporation – Westminster, CO
- Community Building Group, Ltd. – Washington, DC
- Community Development Corporation of Long Island, Inc. – Centereach, NY
- Consumer Credit Counseling Service of Nebraska, Inc. – Omaha, NE
- Consumer Credit Counseling Service of North Central Texas – McKinney, TX
- Covenant Glen United Methodist Church – Missouri City, TX
- Druid Heights Community Development Corp., Inc. – Baltimore, MD
- Greater El Paso Housing Development Corporation – El Paso, TX
- Greater Miami Neighborhoods, Inc. – Miami, FL
- Home Ownership Center – Charlotte, NC
- Housing Authority of Salt Lake City – Salt Lake City, UT
- Jonah Affordable Housing Organization – Jackson, TN
- Jonathon Daniels Community Development Corporation – Selma, AL
- Latino Leadership 2000 – Orlando, FL
- Little Haiti Housing Association, Inc. – Miami, FL
- Mid City Redevelopment Alliance, Inc. – Baton Rouge, LA
- Motor City Blight Busters, Inc. – Detroit, MI
- Neighborhood Finance Corporation – Des Moines, IA
- Neighborhood Housing Services of St. Louis, Inc. – St. Louis, MO
- New London Development Corporation – New London, CT
- Opportunities, Inc. – Watonga, OK
- Opportunity Village – Las Vegas, NV
- Project for Pride in Living, Inc. – Minneapolis, MN
- San Antonio Alternative Housing Corporation – San Antonio, TX
- South Carolina Coalition of Black Church Leaders, Inc. – Columbia, SC

Celebrating 25 Years 1975-2000

Neighborhood Housing Services of St. Louis, Inc.

June 14, 2000

The Honorable Paul Kanjorski
2353 Rayburn House Office Building
U.S. House of Representatives
Washington, DC 20515

Dear Representative Kanjorski:

In speaking with Clifton D. Berry of Fannie Mae's Partnership Office in St. Louis it has come to my attention that the House Banking Subcommittee on Capital Markets and Government Sponsored Enterprises will be holding hearings on June 15 that involve Fannie Mae. Mr. Berry has also told me that your office in particular is interested in the opinions of nonprofit organizations having experience in working with Fannie Mae and Freddie Mac.

Strengthening neighborhoods, improving and preserving housing through partnerships with residents, businesses, and government.

While I am unable to attend the hearing I am writing to express my view that Fannie Mae is doing a tremendous job of responding to the needs of the people of the St. Louis community through their targeted initiatives. They have made considerable contributions to our community as well as others throughout the country in partnership with various Neighborhood Housing organizations. These contributions include grass roots support of nonprofit community development corporations like ours, investing with local governments to forward their housing agendas, investing in low income housing tax credits to address the housing needs of low income renters, taking a leadership role in homeownership training and counseling and the development of lending products that help to combat predatory lending practices. These are just a few examples. Although Freddie Mac does not have an office in St. Louis, you should also know that we are appreciative of their role in a mortgage finance system that continues to deliver great benefits to our community.

As your Committee examines these companies and their role in the mortgage finance system, I can only hope that you are taking a long-term view. It seems to me that the service of the mortgage finance system to our constituents is much better today than it was several years ago, owing to the success of Fannie Mae's Trillion Dollar Commitment. We are also encouraged by the promise of the American Dream Commitment recently announced by Fannie Mae.

4156 Manchester Avenue
St. Louis, MO 63110-3847

Phone:
314.533.0600

Fax:
314.533.0476

NeighborWorks
CHARTERED MEMBER

We applaud the commitments Fannie Mae and Freddie Mac have made to increase homeownership rates and the availability of affordable rental housing. We think that they are on the right track and we would be concerned with any fundamental change in the system that would compromise the ability of these firms to deliver on the promise of their mission to the people we serve.

Sincerely,

Kate Reese

Kate Reese, Executive Director

NEW LONDON
DEVELOPMENT CORPORATION

June 14, 2000

VIA FACSIMILE and U.S.MAIL
202-225-0764

The Honorable Paul Kanjorski
2353 Rayburn House Office Building
U. S. House of Representatives
Washington, DC 20515

Dear Representative Kanjorski:

I am writing to you to inform you on some of the things we are doing with Fannie Mae in the City of New London, Connecticut.

New London is lucky enough to have been selected as one of Fannie Mae's Neighborhood Partnership Initiative communities. I work every day with members of the Fannie Mae staff, and the exciting and difficult housing renovation projects we have underway would not have been possible without the company's support.

Our most advanced housing project is the rehabilitation of two of New London's largest historic buildings into 79 housing units, a minimum of 40% of which will be affordable to low- and moderate-income rental housing.

We are also developing a "homeownership counseling" program in conjunction with Fannie Mae which will provide New London residents with the necessary skills to move from life-long renters to first-time homeowners.

We respectfully hope members of the Subcommittee on Capital Markets, Securities and Government consider the full realm and importance of Fannie Mae's involvement – financing and staff expertise – in your deliberations. Fannie Mae has responded to our community of need and it has meant a great deal to us.

Sincerely,

Damon Hemmerdinger
Director of Real Estate Development

165 State Street • Suite 313 • P.O. Box 2042 • New London, CT 06320
Phone: 860-447-8011 • Fax: 860-447-3833 • http://www.nldc.org

Neighborhood Finance Corporation™

1912 Sixth Avenue
Des Moines, IA 50314

Telephone: 515-246-0010
Fax: 515-246-0112

June 14, 2000

Representative Kanjorski
2353 Rayburn House Office Building
U.S. House of Representatives
Washington, DC 20515

Dear Representative Kanjorski:

I understand that hearings are being held on Thursday, June 15 before the House Banking Subcommittee on Capital Markets and Government Sponsored Enterprises, on the Housing Finance Regulatory Improvement Act. I am writing to you because I think it is important that the Subcommittee consider the views of those in the housing industry that work to expand affordable housing opportunities. Fannie Mae and Freddie Mac work in numerous communities across the country to ensure that all people are given affordable rental and homeownership opportunities and I feel that it is important to recognize their contributions.

Neighborhood Finance Corporation (NFC) is a tax-exempt 501(c) 3 nonprofit affordable housing lender established in 1990 to address the growing deterioration in Des Moines Iowa's low- to moderate-income central city neighborhoods and the related decline in homeownership rates. Since we began lending, NFC has originated over $66.5 million in home purchase and rehabilitation loans and forgivable loans. With an average annual default rate of less than 1%, NFC has played a crucial role in demonstrating the market viability of central city neighborhoods to our partners, including local banks, insurance companies, and Fannie Mae.

Fannie Mae is working with NFC to make an important contribution to affordable housing efforts in Des Moines. For six years they have purchased low down payment acquisition rehab loans from us. We have sold Fannie Mae over $15 million in loans during this time. Being able to sell loans to Fannie Mae has enhanced our ability to revitalize neighborhoods in Des Moines. Last year we worked with them to add a 1% down payment from the borrower option to the loans we sell them. This very low down payment option has opened up homeownership to more families in Des Moines. This year Fannie Mae worked with NFC and the state finance agency to allow NFC to participate in the Iowa's first time homebuyer program with our rehab loans. This has enabled us to offer a 7.25% interest rate to our central city borrowers. In a few short weeks this has made a big impact. Nine of our twelve current applications for home purchase/rehab loans are using the 7.25% Iowa's first time homebuyer program. Most of these families would not have other wise been able to

afford home ownership. Please understand that our customer base is 65% low income and 25% minority (compared to Iowa's statewide 3% minority population).

We count on Fannie Mae's commitment to work with us to extend homeownership as part of our neighborhood efforts and we strongly discourage Members of Congress from doing anything that would negatively impact the cost of homeownership in this country. Any increased fees, taxes, or additional regulatory burden will only have the effect of increasing the cost of home ownership to the lowest income families in America. This means that more families will not be able to attain the American dream.

Thank you for your support.

Sincerely;

Gary Dodge
Executive Director

Cc: Senator Tom Harkin
Senator Charles Grassley
Representative Greg Ganske
Representative James Leach
Representative Jim Nussle
Representative Leonard Boswell
Representative Tom Latham

JUN 19 2000

FIGHT BLIGHT
MOTOR CITY
BLIGHT BUSTERS INC.™
STABILIZE REVITALIZE

The Honorable Paul Kanjorski
Member of Congress
2353 Rayburn House Office Building
Washington, DC 20515

June 14, 2000

Dear Congressman Kanjorski:

I have read with interest recent allegations that Fannie Mae is not doing enough for minority populations and urban areas. A variety of groups, from HUD officials to large financial companies, have made these allegations. I want you to know that nothing in my experience of working with Fannie Mae over the past three years supports any of these charges. In fact, just the opposite is true. Fannie Mae is one of the few private companies that have gone out of its way to support neighborhood redevelopment and minority homeownership in Detroit.

According to recent news stories, Fannie Mae has invested over $560 million in Detroit, helping thousands of families become first time homebuyers. According to the Detroit Free Press, over 72 percent of their loans served minority families, and a map of these loans prepared by the Free Press showed that they are located in nearly every neighborhood in the city. But these numbers only tell part of the story. Whenever we have needed help, whether it was a grant application, event sponsorship, technical assistance, or simply time to listen to our problems and help us come up with solutions we may not have considered, Fannie Mae has been there.

Motor City Blight Busters, Inc. was founded in 1988 with the mission and goal to stop the spread of blight in the city and to help stabilize and revitalize Detroit's neighborhoods. For over a decade, Blightbusters has built a volunteer base of more than 10,000 and has completed thousands of clean-ups, beautification and renovation projects. Blightbusters has been instrumental in putting together a coalition of partners who cooperate on projects throughout the City of Detroit. Using properties acquired through private donations, Wayne County, and the City of Detroit, Blightbusters works in conjunction with its coalition of partners and its army of volunteers to make homeownership available for low- and moderate-income families.

P.O. BOX 19654 · DETROIT, MICHIGAN 48219
OFFICE: (313) 255-4355 · FAX: (313) 255-6056
HTTP://WWW.DDC.COM/BLIGHTBUSTERS

Fannie Mae's Detroit Partnership Office has led the company's involvement in our neighborhoods. However, I don't want you to assume that a few community outreach staff have done all of the work. Over the past three years, I have hosted Fannie Mae officials from Chicago and Washington, and Fannie Mae's past and current chairmen, Jim Johnson and Frank Raines, have personally toured our neighborhoods.

Given this tremendous involvement in making our cities work, I would hope that your committee would look into why some insist on running down the good works of this company. What do they have to gain from harming Fannie Mae? I would be interested to know this, since our neighborhoods and our community have much to lose should they prevail.

Sincerely,

John George, President
Motor City Blight Busters

Little Haiti Housing Association, Inc.

"Building Homes, Building Lives, Building Community"

June 14, 2000

Dear Representative Kanjorski:

I am writing to request that the House Banking Subcommittee on Capital Markets and Government Sponsored Enterprises take into consideration the views of those in the housing industry that work to expand affordable housing opportunities.

Little Haiti Housing Association has worked closely with Fannie Mae in South Florida to tackle the hard issues regarding mortgage finance for new immigrants in very low- and low-income communities. An example of this partnership is the creation of the Neighborhood Infill Stabilization Program (NISP).

Most low-income neighborhoods contain vacant lots, and abandoned or sustained housing units which contribute to neighborhood decline by deflating property values, and contributing to trash dumping and crime. The percentage of families in low-income communities who own their own home is often low in comparison to renters, thus reducing long term stability and resident involvement for community development. In an economically depressed neighborhood, the appraised value of the single family housing stock is generally below the cost of providing new housing and rehabilitating existing housing to current code conditions. This makes the production of new quality housing units economically viable and continues to promote property values that do not reflect the true cost of providing affordable housing. NISP addresses these issues and promote the revitalization of these low-income communities.

I respectfully request that the efforts of this organization be recognized in the committee's records on behalf of community development corporations in South Florida.

Sincerely,

Antoine Auguste
Executive Director

181 NE 82nd Street, 2nd Floor Miami, Florida 33138
Telephone: (305) 759-2542 Fax: (305) 754-9200

LATINO LEADERSHIP 2000

June 13, 2000

The Honorable Paul Kanjorski
2353 Rayburn House Office Building
U.S. House of Representatives
Washington, DC 20515

Dear Representative Kanjorski:

I represent a community-based organization with special interest in issues affecting the Hispanic population of Central Florida. I understand that on Thursday, June 15, 2000, hearings will be held before the House Banking Subcommittee on Capital Markets and Government Sponsored Enterprises, on the Housing Finance Regulatory Improvement Act. Therefore, I would like the subcommittee to consider the views of local housing and community based organizations that work to expand affordable housing opportunities for minorities and lower income persons.

Fannie Mae has been very supportive to our organization. Recently, they helped us sponsor a community fair in a highly populated minority neighborhood. More than 2,000 persons attended this community fair. Fannie Mae also sponsored the publication of a community services directory . Furthermore, the Fannie Mae Orlando Partnership Office sponsored and organized the first Hispanic Housing Industry Roundtable in Osceola County. We are presently working with Fannie Mae in reaching out to the Hispanic community and other minority and underserved populations with education, information and other resources needed to bring homeownership opportunities to underserved populations.

We appreciate the opportunity to share with you some of Fannie Mae's contributions and our personal experience with the Orlando Partnership Office.

Sincerely,

Carlos Guzman, Executive Director
Latino Leadership 2000

MIDCITY
REDEVELOPMENT ALLIANCE, INC.

June 14, 2000

The Hon. Richard Baker
United States House of Representatives
U.S. House of Representatives
434 Cannon House Office Bldg.
Washington, DC 20515

VIA FAX TO: (202) 225-7313

Dear Congressman Baker:

Please allow us to share some information with you about the relationship Mid City Redevelopment Alliance has enjoyed with Fannie Mae and the Fannie Mae Foundation since 1996. As the first not for profit organization created in Baton Rouge to address the social and economic needs of the mid-city region, a cornerstone of our work has been to expand home ownership opportunities among low and moderate-income families.

To that end, we have garnered significant support from local lenders, national foundations and your office as we work toward educating families about the basics of home ownership through our First Time Home Buyers Educational Seminars. As you know, over 1,650 families have graduated from this course since 1991 and nearly 50% have gone on to purchase home—something that has strengthened the civic fabric of our entire community.

Among our many partners has been the Fannie Mae Foundation. Over the past four years, the Foundation has contributed $10,000 per year to allow us to provide home buyer education services at no cost to eligible clients. Currently, we have a pending request of $50,000 before the Fannie Mae Foundation for the creation of a full-service Home Ownership Center. The Home Ownership Center, the first of its kind in Baton Rouge, will offer a wide-range of comprehensive services to lower-income families at no cost. This vital community resource will offer budget and savings counseling, pre and post-purchase counseling, first time home buyer education, home repair and maintenance training and consumer education on a variety of topics pertaining to home ownership. The creation of a comprehensive Home Ownership Center is very important to reaching all those families here in East Baton Rouge Parish who wish to achieve the American Dream of home ownership.

From our founding, we have endeavored to work very hard with a wide range of diverse partners for the single goal of creating a more sound and healthy community.

Thank you for allowing us to share this information with you. Both you, Fannie Mae and the Fannie Mae Foundation have been invaluable partners in our work to create a safe and vibrant center city here in Baton Rouge. For the sake of the clients we serve, we are hopeful this relationship will continue in the years ahead.

419 North 19th Str
Baton Rou
Louisiana 708

(225) 346-10
FAX (225) 344-61

Sincerely,

Perry J. Franklin
Executive Director
Mid City Redevelopment Alliance, Inc.

cc: The Honorable Rep. Paul Kanjorski
Fannie Mae Partnership Office, New Orleans

JONAH AFFORDABLE HOUSING ORGANIZATION
212 Tanyard Street
PO Box 7444
Jackson, Tennessee 38302-7444
(901) 427-0817 FAX: (901) 427-0944

June 14, 2000

The Honorable Paul Kanjorski
2353 Rayburn House Office Building
U.S. House of Representatives
Washington, DC 20515

Dear Representative Kanjorski:

Jonah Affordable Housing Organization (JAHO) is a non-profit Community Housing Development Organization (CHDO) organized in 1995 to address the need for affordable Housing for low-income families in Rural West Tennessee. A CHDO is a community housing organization composed of low-income residents or representatives of the community it serves.

I understand that your subcommittee on Capital Markets and Government Sponsored Enterprises will hold hearings tomorrow on the Housing Finance Regulatory improvement Act. I am writing to you because I think it is important that the subcommittee considers the views of those on the front line in the battle for increased affordable housing opportunities.

The clientele we serve in West Tennessee have an average income below 80% of $38,500. $38,500 is the higher Area Medium Income of the all the counties we serve. In Madison and Haywood County Fannie Mae in particular has been actively involved in affordable housing and has taken a real interest in small neighborhood based organizations such as ours. Fannie Mae has been pro-active and willing to work to help us leverage the resources we have. They have been willing to step in when many others have not.

As you take testimony on the impact the government-sponsored entities have on our system of housing finance, I hope that you will take into account the real world experience of community non-profits such as ours.

Sincerely,

Shirley Richmond

Shirley Richmond
Executive Director

Providing Safe and Affordable Housing

THE JONATHAN DANIELS COMMUNITY DEVELOPMENT CORPORATION

P.O. Box 1315 . Selma, Alabama 36702 . 334 872-3265 . 334 872-3254 Fax
Email: joyjdcdc@bellsouth.net

Building Communities from the Inside Out......

June 14th, 2000

The Honorable Paul Kanjorski
2353 Rayburn House Office Building
U.S. House of Representative
Washington, DC 20515

Dear Representative Kanjorski:

I understand that hearings are being held on Thursday, June 15 before the House Banking Subcommittee on Capital Markets and Government Sponsored Enterprises, on the Housing Finance Regulatory Improvement Act.

I am Executive Director of the Jonathan Daniels Community Development Corporation in Selma, AL The JDCDC is dedicated to expanding homeownership opportunities and developing initiatives that will improve the life of all people that live in the Alabama Black Belt. I am writing to you because I think it is important that the Subcommittee consider the views of those in the housing industry that work to expand affordable housing opportunities. Fannie Mae and Freddie Mac make enormous contributions to affordable housing initiatives.

In particular, Fannie Mae has provided critical seed money to help the Jonathan Daniels CDC get established, including funds that permitted CDC leadership to attend an education retreat and funds to purchase computer equipment. Fannie Mae also sponsored a housing forum of key housing leaders, and sponsored a homeownership event to provide greater awareness of homeownership opportunities. In addition, Fannie Mae has provided the JDCDC software—its Desktop Home Counselor—that facilitates housing counseling by the JDCDC. Working with its lender partners here in Selma, Fannie Mae is also helping expand the availability of mortgage credit for residents of the Black Belt.

I wanted to make sure that the Subcommittee recognize the contributions of the GSE's to affordable housing.

Sincerely,

Joyce M. Kendrick

Joyce M. Kendrick
Executive Director

HomeOwnership Center

an Education and Counseling Service

June 14, 2000

The Honorable Paul Kanjorski
2353 Rayburn House Office Building
U.S. House of Representatives
Washington, DC 20515

Dear Representative Kanjorski:

I am concerned that the House Banking Subcommittee on Capital Markets and Government Sponsored Enterprises, at their hearing on Thursday, June 15, on the Housing Finance Regulatory Improvement Act, will not have the input of housing industry professionals who work to expand affordable housing opportunities. You should be aware that Fannie Mae and Freddie Mac make enormous contributions in affordable housing.

The HomeOwnership Center has been able to expand credit education in North Carolina in large measure due to financial and other support from Fannie Mae. Thousands of students in the Charlotte-Mecklenburg, Gaston County and Harnett County school systems are able to receive financial literacy training using textbooks provided by the HomeOwnership Center, in part though funding received from Fannie Mae. This education will prepare the students to use credit responsibly. In other words, the students will be equipped to be good renters and homeowners.

It is important that you know how the GSEs are helping in the communities they serve. Thank you for your help in making this known.

Sincerely,

Vivian S. Puryear

Vivian Puryear
Executive Director

1300 Baxter Street ◆ Suite 260 ◆ Charlotte, NC 28204
704-343-0542 ◆ Fax 704-376-8709

HOUSING
AUTHORITY
OF SALT LAKE CITY

1776 South West Temple
Salt Lake City, Utah 84115
VOICE (801) 487-2161
FAX (801) 487-3641
TDD (801) 487-3361

June 14, 2000

The Honorable Paul Kanjorski
2353 Rayburn House Office Building
U.S. House of Representatives
Washington, D.C. 20515

Via Facsimile: 202-225-0764

Dear Representative Kanjorski:

I feel it's very important for the Capital Markets and Government Sponsored Enterprises Subcommittee to know all of the great things Fannie Mae is doing in our community. I hope that you consider this information during your hearing on June 15 to discuss the Housing Finance Regulatory Improvement Act. Several of the provisions in this bill would hinder the work we do with Fannie Mae.

Fannie Mae has been actively involved in our community developing programs to lower mortgage costs for our consumers. We have implemented several successful partnerships with Fannie Mae and local lenders to provide affordable housing for low and moderate income Utahns. We have other projects in various stages of development that could possibly be jeopardized should the Baker Bill be passed in it's current form.

As the bill is currently drafted, it would subject any further partnerships or innovative loan products we develop with Fannie Mae to a burdensome and unwieldy regulatory framework which ultimately impacts those families we are trying to assist. I urge the members of the Committee to move cautiously as they consider this legislation.

I look forward to many years of partnering with Fannie Mae to provide affordable housing in Utah. I appreciate your help and support in continuing to keep Fannie Mae a user friendly agency to those of us who depend on their services to provide housing in our communities.

Sincerely,

Kathy Ricci

Kathy Ricci
Finance Manager

Equal Housing Opportunity

GREATER MIAMI NEIGHBORHOODS, INC.
Generating Affordable Housing

June 14, 2000

The Honorable Paul Kanjorski
2353 Rayburn House Office Building
U.S. House of Representatives
Washington, D.C. 20515

Dear Representative Kanjorski:

We would appreciate the opportunity to express our view in light of the hearing that will be held on Thursday, June 15 before the House Banking Subcommittee on Capital Markets and Government Sponsored Enterprises, on the Housing finance Regulatory Improvement Act. We think it is important that the Subcommittee consider the views of those in the housing industry that work to expand affordable housing opportunities.

Greater Miami Neighborhoods (GMN) is a not-for-profit organization incorporated in May 1985, operates as a public and private partnership to provide affordable housing opportunities for very low-income individuals and families throughout the State of Florida. Since its inception, GMN has worked in partnership with more than 25 local, community based nonprofit organizations to develop more than 5,000 affordable housing units, valued in excess of $300 million.

Fannie Mae's contribution to this community in the area of affordable housing has been enormous. Fannie Mae works closely with GMN to provide affordable housing opportunities to very low- and low-income families. We are currently working with Fannie Mae to support the Congressional Welfare-to-work mandate. Fannie Mae has created a mortgage finance program to assist former welfare and public assistance recipients and very-low income individuals move from renting to homeownership as a result of their now stable employment. GMN will work closely with Fannie Mae to provide outreach to this targeted community.

We hope that you will ensure that the subcommittee's hearing record make note of the invaluable contributions made by Fannie Mae.

Sincerely,

Agustin Dominguez
President

300 N.W. 12TH AVENUE, MIAMI, FLORIDA 33128
◆ PHONE (305) 324-5505
◆ FAX (305) 324-5506

THE
GREATER
EL PASO
CHAMBER OF
COMMERCE
SINCE 1899

June 13, 2000

The Honorable Paul Kanjorski
2353 Rayburn House Office Building
U.S. House of Representatives
Washington, DC 20515

Via Facsimile: 202-225-0764

Dear Representative Kanjorski:

I am writing to you to express my support for Fannie Mae and Freddie Mac. I realize that the Government Sponsored Enterprises Subcommittee of the House Banking Committee is holding a hearing on Thursday, June 15. The Greater El Paso Housing Development Corporation has worked very closely with Fannie Mae over the past several years to create more opportunities for homeowners.

Fannie Mae has been instrumental in supporting our endeavors, such as the first Parade of Affordable Homes that we will host together this weekend. In addition, Fannie Mae has assisted us in the development of a mortgage product that was used to make over 50 low-income El Pasoans first-time homebuyers. Most recently, Fannie Mae has been extremely involved with us in the El Paso Downtown Partnership, an effort to revitalize and bring new homeownership opportunities to Downtown El Paso. Fannie Mae was also a key partner in the development of an affordable housing week in El Paso several years ago.

Please understand that Fannie Mae is a vital partner in this community, and we look forward to working with them in the future.

Thanks for your help with this matter.

Sincerely,

Demetrio Jimenez
Greater El Paso Housing Development Corporation

Ten Civic Center Plaza. El Paso, TX 79901 • 915 534-0500 • Fax 915-534-0513 • www.elpaso.org
Celebrating Our Second Century Of Service

DRUID HEIGHTS COMMUNITY DEVELOPMENT CORP., INC.
1821 McCulloh Street
Baltimore, Maryland 21217
Tel : (410) 523-1350
Fax: (410) 523-1374

June 13, 2000

The Honorable Paul Kanjorski
2353 Rayburn House Office Building
U.S. House of Representatives
Washington, D.C. 20515

Dear Representative Kanjorski:

I understand that hearings are being held on Thursday, June 15, 2000 before the House Banking Subcommittee on Capitol Markets and Government Sponsored Enterprises, on the Housing Finance Regulatory Improvement Act. I am writing to you because I think it is important that the Subcommittee consider the views of those of us in the housing industry that work to expand affordable housing opportunities.

Druid Heights Community Development Corporation (DHCDC) is a not-for-profit, 501 (c) (3) community-based organization. Our mission is to promote the general welfare and betterment of the community in planning for and effecting the development and provision of low and moderate cost housing, small businesses, recreational facilities, employment training and business opportunities to persons of low and moderate income who reside in the Druid Heights community and to facilitate community participation in all City, State and Federal Urban Renewal Plans for the Druid Heights Urban Renewal Area.

DHCDC is one of many small, not-for-profit community organization's that currently benefit from positive interaction with Fannie Mae and Freddie Mac. For the past five years, Fannie Mae has generously contributed invaluable technical assistance to our housing development and homeownership counseling programs. As a result of Fannie Mae's contributions, we provide quality, comprehensive housing counseling to first-time home buyers. To date, as a HUD certified housing counseling agency, we have counseled and trained more than five hundred low to moderate income families and individuals. Many of them have gone on to become successful home owners.

Across the USA, many agencies are struggling to stabilize deteriorating neighborhoods. We believe that without the help, interaction and contributions of Fannie Mae and Freddie Mac our jobs would be much more difficult and opportunities for communities to access even greater resources to assist in their efforts to survive would cease.

Thank you for your time and consideration.

Sincerely,

Jacquelyn D. Cornish
Executive Director

CONSUMER
CREDIT
COUNSELING
SERVICE OF NORTH CENTRAL TEXAS, INC.

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June 14 2000

The Honorable Paul Kanjorski
2353 Rayburn House Office Building
US House of Representatives
Washington DC 20515

Via facsimile: 202 225 0764

Dear Representative Kanjorski:

I feel that it is very important for the Capital Markets and Government Sponsored Enterprises Subcommittee know of all the great things that Fannie Mae and Freddie Mac are doing in our community. I hope that you consider this information during your hearing on June 15 to discuss the Housing Finance Regulatory Improvement Act. Several of the provisions in this bill would hinder the work we do with Fannie Mae and Freddie Mac.

The GSEs are very actively involved in our market to lower mortgage costs for the consumer. An example of something that Fannie Mae is doing in our community includes the creation of a new one percent down payment mortgage for individuals earning less than 100 percent of the area median income ($38,100) in Texarkana. This mortgage pilot, which is available through Hibernia National Bank throughout East Texas and Louisiana, allows qualified borrowers to make a down payment from their own funds equal to one percent of the sales price or $500.00 whichever is greater. The remaining two percent of the down payment can come from a grant or a gift. The interest rate on the loan is the market interest rate for a 30-year conventional mortgage. If HR 3703 passes, it will be harder for Fannie Mae to provide products such as this to consumers.

I look forward to many years of partnerships with Fannie Mae and Freddie Mac to increase the homeownership rate.

I appreciate your help and support.

Sincerely,

Joanne Haney

Joanne Haney
Counselor

Covenant Glen United Methodist Church

Dr Robert E Childress, Pastor

June 14, 2000

The Honorable Paul Kanjorski
U. S. House of Representatives
2353 Rayburn House Office Building
Washington, DC 20515

Via Facsimile 202-225-0764

Dear Representative Kanjorski:

It is our understanding that the House Banking Subcommittee on Capital Markets and Government Sponsored Enterprises will be holding hearings on Fannie Mae and Freddie Mac. We would like the committee *to know of our views on these* organizations.

While most of our contact with GSEs has been with Fannie Mae, we know that Freddie Mac's role in housing finance is essentially the same as Fannie Mae's. We also, know that Freddie Mac, like Fannie Mae, is working in communities like ours to finance housing for families. Therefore, we would like to express our support for both for these organizations.

Fannie Mae has *made a* considerable contribution to our community. Two years ago, they became one of our key partners and made a $100,000 grant to our community to help us assess our needs for housing and develop a strategy for meeting those needs. Since then, they have provided invaluable guidance, introductions to new valuable partners, and a commitment of a mortgage product tailored for *the community. The* mortgage product has been instrumental in getting a builder to commit to purchase lots in our new 207-lot single-family subdivision for families at or below the area medium income.

From my conversations with other communities like ours, we know that Fannie Mae is doing great work throughout the country. We feel blessed that organizations like Fannie Mae and Freddie Mac exist, and we look forward to working with them for a long time.

Sincerely,

Robert Childress

Robert Childress
President

401 Present Street • Missouri City, Texas 77489 • Phone 281-499-8788 • Fax 281-499-9119

C·B·G LTD.
COMMUNITY
BUILDING
GROUP, LTD.

The Honorable Paul Kanjorski
2353 Rayburn House Office Building
U. S. House of Representatives
Washington, DC 20515

Dear Representative Kanjorski:

It is my understanding that hearings are being held tomorrow, before the House Banking Subcommittee on Capital Markets and Government Sponsored Enterprises, on the Housing Finance Regulatory Improvement Act. As these hearings are held, I believe it is very important that that the Subcommittee is aware of the views of those involved in the housing industry on a day-to-day basis, who are working to increase affordable housing opportunities.

In my experience, Fannie Mae and Freddie Mac make invaluable contributions to expanding affordable housing. I have worked personally with Fannie Mae's Washington, DC Partnership Office on several occasions, and have found Fannie Mae willing to be both creative and flexible in structuring financial transactions which impact affordable housing. One example of a recent project we are involved with is the redevelopment of the Montana Terrace public housing complex; formerly one of Washington, DC's most notorious public housing properties. With Fannie Mae's help in financial resources and technical consultation, we were able to gain approval and financing for the redevelopment 38 derelict public housing apartments as 28 fully modernized townhomes. Fannie Mae's financial investment enabled residents of the public housing complex to learn new job skills in fiber optic cable installation. The project is under construction right now, and the first buyers will move in later this fall. These buyers include former public housing residents who, through the Fannie Mae assisted jobs program, have been able to get off welfare and become homeowners.

Moreover, as a consequence of this public housing redevelopment and Fannie Mae's involvement, six acres of vacant property next to the public housing complex is now developed as 37 affordable single-family detached homes. These homes have attracted families to move back into the District and helped to stabilize the surrounding community. Fannie Mae also participated in the construction financing of these new homes. Fannie Mae's involvement in both Montana Terrace and the vacant tract of land was essential to the feasibility of each project.

I just thought it important that the hearing record reflect these real life examples of how Fannie Mae makes a difference in working with affordable housing producers.

Sincerely,

Andy Botticello
Community Building Group

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June 14, 2000

The Honorable Paul Kanjorski
U. S. House of Representatives
2353 Rayburn House Office Building
Washington, DC 20515

Dear Representative Kanjorski:

I am writing with respect to the hearings scheduled for Thursday, June 15 before the House Banking Subcommittee on Capital Markets and Government Sponsored Enterprises, on the Housing Finance Regulatory Improvement Act. I think it is important that the Subcommittee consider the views of those in the housing industry that work to expand affordable housing opportunities.

As a NeighborWorks organization, active in Neighborhood Reinvestment Corporation's Campaign for HomeOwnership, I would like to share the positive experiences Community Development Corporation of Long Island has had with Fannie Mae. For approximately two years we have been actively working with Fannie Mae's New York Partnership Office. They have consistently been a friend and supporter of our affordable housing programs and initiatives.

On Monday, June 12, we jointly announced a major Section 8 Homeownership initiative that will allow low-wealth families achieve the American dream of homeownership. Nationally, we are one of eight HUD approved demonstration programs and our initiative has required the close involvement of many housing partners. Our Section 8 Homeownership Program is unique in its structure, which provides for a first mortgage and a very low interest bearing second mortgage. Fannie Mae's support has been integral to the development of this initiative. Their ability to be responsive and move decisively and quickly has been key to the successful rollout of this program

In addition to the purchase of the first mortgages originated under flexible underwriting parameters by our lender partners, Fannie Mae has committed to a $1 million below-market, ten year term investment that will fund the revolving loan pool for the second mortgage financing structure. This will make homeownership possible for our very low-income families. Without the support and guidance of Fannie Mae, it would have been very difficult to bring this initiative to reality as quickly and efficiently as we have done.

Fannie Mae has helped CDC to better serve the needs of all of our constituents. Their support of our Section 8 Homeownership Program, their Home Choice mortgage product which serves the needs of people with disabilities, their "user friendly" acquisition and rehabilitation mortgage product which assists us in stabilizing our older neighborhoods, and the technical and supportive services they offer to us, have all enabled CDC to accomplish its mission. They have consistently demonstrated the value they bring and their willingness to respond quickly and favorably to initiatives that support the housing needs of low to moderate and minority families.

We believe it is important that the Subcommittee hearing record reflect the recognition of their tangible contribution to the efficiency and delivery of affordable housing products and opportunities to the low income Long Islanders we are dedicated to serving.

Yours sincerely,

Wilbur Klatsky
President

CONSUMER
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SERVICE
OF NEBRASKA, INC. MEMBER NO 37001

DONALD A. LEU, President & CEO
CYNTHIA J. PIERCE, Vice President, Operations

June 14, 2000

The Honorable Paul Kanjorski
2353 Rayburn House Office Building
U.S. House of Representatives
Washington, DC 20515

Dear Representative Kanjorski:

I would like to introduce myself. I am Theresa Pinkham, Housing Director of Consumer Credit Counseling Service of Nebraska, Inc. I know that at this time, the House Banking Subcommittee on Capital Markets and Government Sponsored Enterprises is considering legislation that can greatly impact the lives of homebuyers. This piece of legislation is the Housing Finance Regulatory Improvement Act. I work in the housing industry in the capacity of trying to increase affordable housing opportunities. We have found through our experiences in the industry that Fannie Mae is an invaluable part of the affordable housing process.

Our involvement with Fannie Mae has been to implement in innovative program allowing past participants of our Debt Management services to purchase a home or refinance their existing home at a market rate although they had credit problems in the past. This program is truly one that CCCS can embrace because it provides a second chance at the American dream for consumers who have lost hope. Many of them are prepared to pay higher than necessary rates and fees at other lenders that would consider them "high risk."

Programs like this are the only affordable and wise options for our consumers. This program had been highly successful for many reasons. Least of not is that it is a locally coordinated program that involves a committed lender, CCCS and Fannie Mae. Legislation such as this would severely hamper similar programs from having such a success by tying them up in unnecessary delays. Please help us continue providing innovative programs for consumers in a timely basis and fulfilling our mission to put the consumers needs first.

I fear that if the Housing Finance Regulatory Improvement Act is approved, it will impede progress towards affordable housing opportunities rather than furthering them. I know that this bill you are currently considering is of great importance and I wanted to let you know what some of us that work everyday in this field our thinking. I appreciate you taking the time out of your busy schedule to consider my thoughts.

Respectfully Submitted,

Theresa Pinkham

NFCC

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June 14, 2000

The Honorable Paul Kanjorski
2353 Rayburn House Office Building
U.S. House of Representatives
Washington, DC 20515

Via facsimile: 202-225-0764

Dear Representative Kanjorski:

I am writing to express my views of Fannie Mae and Freddie Mac before the June 15 hearing being held by the House Banking Subcommittee on Capital Markets and Government Sponsored Enterprises. We have worked with these two GSEs for many years to put more people in homes of their own. Fannie Mae and Freddie Mac have made considerable contributions to our community as well as others throughout the country.

Colorado Rural Housing Development Corporation is one of over 100 members of Neighborhood Reinvestment Corporation who has launched a second Campaign for Home Ownership 2002. Two vital partners in the Campaign are Freddie Mac and Fannie Mae. Several examples of things that we have been able to accomplish by partnering with Fannie Mae and Freddie Mac include, creating mortgage products, assisting with down-payment and developing new housing stock.

With Fannie Mae, we have been working on Employer Assisted Housing. This mortgage product combines dollars for down-payment assistance from an employer, which addresses the lack of down-payment assistance that is available. In addition, Fannie Mae invested $3 million with the state of Colorado to assist with land acquisition, site prep and construction loans with non-profits, local government and housing authorities. This partnership with the State of Colorado to leverage housing dollars will increase the affordable housing stock in under-served rural areas of Colorado. Further, the announcement of the Self Help mortgage product which provides access to mortgages for clients unable to obtain traditional financing. This product requires a down-payment of only $750.00 and costs less than a FHA loan. In Colorado last year, Fannie Mae invested over $5 billion and assisted more than 50,000 families. We are proud to partner with Fannie Mae and Freddie Mac and look forward to continuing a strong working relationship with their Colorado Partnership Office in the future.

We applaud the commitment Fannie Mae and Freddie Mac have made to increasing homeownership opportunities. We look forward to working with them in the years to come as we bring homeownership within the grasp of more American families.

Sincerely,

Deborah Hughes
Associate Director

A proud member of the NeighborWorks network

CITY VISION
MINISTRIES

June 14, 2000

The Honorable Paul Kanjorski
2353 Rayburn House Office Building
U. S. House of Representatives
Washington, D. C. 20515

Fax No. 202-225-0764

Dear Congressman Kanjorski,

I am writing to state my support for the activities of Fannie Mae in my community. City Vision Ministries, Inc. has worked very closely with Fannie Mae over the past several years to create more opportunities for home ownership.

Fannie Mae has supported City Vision Ministries, Inc. effort to build new housing, rehabilitate deteriorating housing, and train families for successful home purchases and long term ownership in Kansas City, Kansas. In addition to providing single family mortgage financing for purchases of our homes, Fannie Mae has funded property acquisition of development parcels, construction of new single family homes, and home buyer education training. Fannie Mae continues to be a good partner in the revitalization of Turtle Hill, a community redevelopment area that is bringing a mix of incomes back into what was previously a blighted neighborhood.

I wanted you to know, in advance of House Banking Committee hearing this Thursday, that Fannie Mae is important to my community.

Thank you for your consideration.

Sincerely,

John Harvey
Executive Director

JH:pw

"Healthy, Sustainable Urban Neighborhoods"

John Harvey, Executive Director 1321 N. 7th Street Kansas City, KS 66101 (913) 371-5200 • Fax (913) 371-2555

Buffalo NHS, Inc.
NEIGHBORHOOD HOUSING SERVICES

June 14, 2000

The Honorable Paul Kanjorski
2353 Rayburn House Office Building
U. S. House of Representatives
Washington, DC 20515

RE: House Banking Subcommittee on Capital Markets and Government Sponsored Enterprises

Dear Representative Kanjorski:

I am writing to you regarding the hearings being held tomorrow on the Government Sponsored Enterprises by the House Banking Subcommittee. I am the Executive Director of the Buffalo Neighborhood Housing Services, Inc. (BNHS). As a housing corporation working on the front lines in Buffalo, NY, I can attest to the enormous contributions that Fannie Mae brings to our local efforts to expand affordable housing opportunities.

Through their Partnership Office (PO), Fannie Mae particularly has contributed to the effectiveness of our agency and to the work being done in the region on expanding homeownership opportunities. Specifically, the local PO is working with us to implement a Down Payment Assistance Investment Note that will initially provide down payment assistance to 100 families in the local area. In addition, the PO also initiated our contact with the Erie County Department of Social Services (DSS) that has resulted in the signing of a Memorandum of Understanding between BNHS and the Erie County DSS. This memorandum provides for a collaborative effort on counseling households as they move from welfare to employment into homeownership. The PO office has also been actively involved in support of our homebuyer counseling initiatives and our annual Affordable Home Show.

Finally, I am aware of Fannie Mae's involvement locally on a large initiative with the State University of New York at Buffalo in a large neighborhood improvement effort surrounding the school's South Campus neighborhood.

Fannie Mae's efforts, through their local and regional offices provide visible evidence of housing support across the cities and towns of our region. I thought that it was important that you have this information for the hearings so that their contributions may be recognized. I would urge you, and your colleagues to consider these contributions during your deliberations.

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BERNAL HEIGHTS NEIGHBORHOOD CENTER
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June 14, 2000

The Honorable Paul Kanjorski
2353 Rayburn House Office Building
U.S. House of Representatives
Washington, DC 20515

Dear Representative Kanjorski:

I understand that hearings are being held on Thursday, June 15th before the House Banking Subcommittee on Capital Markets and Government Sponsored Enterprises, on the Housing Finance Regulatory Improvement Act. I am writing to you because I think it is important that the Subcommittee consider the views of those in the housing industry that work to expand affordable housing opportunities.

Fannie Mae makes enormous contributions by providing debt and equity financing for the development of affordable rental housing. We have worked with Fannie Mae on the development of Bernal Gateway in San Francisco's Mission District. When completed, Bernal Gateway will provided 55 units of much needed affordable rental housing for San Francisco residents. Fannie Mae provided $2.1 million in permanent financing in partnership with ARCS Commercial Mortgage and the AFL-CIO Housing Investment Trust.

Fannie Mae is working with nonprofit organizations, such as ours, to develop solutions to the affordable housing crisis we face in San Francisco. Moreover, their presence in our market, through the Bay Area Partnership Office, allows Fannie Mae to work with affordable housing providers on a day to day basis. We thought it was important that the hearing record recognize Fannie Mae's contributions.

Sincerely,

Mauricio Vela

Mauricio Vela
Executive Director

ASOCIACION DE PUERTORRIQUEÑOS EN MARCHA, INC.
2147 North Sixth Street
Philadelphia, Pennsylvania 19122
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Fax: (215) 232-9450

A HUMAN SERVICES ORGANIZATION

JESUS M. SIERRA, Ph. D.
Executive Director

HILDA ARTEAGA
President

June 14, 2000

The Honorable Paul Kanjorski
2353 Rayburn House Office Building
U.S. House of Representatives

Dear Representative Kaojorski:

On Thursday June 15, 2000 the House Banking Subcommittee on Capital Markets and Government Sponsored Enterprises will be holding hearings on June 15, 2000, on the Housing and Finance Regulatory Improvement Act As a leading member of the subcommittee, I think it is important that you are aware of the support Fannie Mae has provided neighborhood-based nonprofits.

The Asociación de Puertorriqueños en Marcha (APM) is a non-profit developer serving the residents of Eastern North Philadelphia, in the City of Philadelphia. Fannie Mae is currently supporting a market study to determine the housing needs and values within lower North Philadelphia. While APM has developed more than 200 units of affordable rental housing in the area, homeownership opportunities have not been viable. However, now that the neighborhood is home to more of the required services necessary to attract homeowners, APM intends to build 104 home that will be sold to eligible homebuyers. In 1966 APM undertook the development of neighborhood retail strip that included a grocery store. Fannie Mae, through its American Community Fund, made an equity investment in the supermarket that made the project feasible. The supermarket now serves as a neighborhood anchor and is spurring others to invest. Without Fannie Mae's equity investment, the supermarket could not have been built and the neighborhood's ability to attach additional investment, including homebuyer's would be more limited.

This is just one example of Fannie Mae's willingness to support community revitalization efforts in Philadelphia neighborhoods.

Sincerely,

Rose Gray

Rose Gray
Housing Director

A United Way Agency

NHC
The United Voice for Housing

June 14, 2000

The Honorable Paul E. Kanjorski
United States House of Representatives
2353 Rayburn House Office Building
Washington, DC 20515-3811

Dear Congressman Kanjorski:

We understand that the Capital Markets, Securities and Government Sponsored Enterprises (GSEs) Subcommittee of the House Banking and Financial Services Committee will hold a hearing on H.R. 3703 on June 15, 2000 and we are dismayed at the curious omission of participants from the housing industry on the witness panels.

Since 1931, the National Housing Conference (NHC), a coalition of affordable housing and community development experts from the public and private sectors, has been an essential source of broad, nonpartisan information on housing policy issues.

We have enclosed a copy of *Housing America's Working Families*, a recently released report commissioned by NHC's research affiliate the Center for Housing Policy that documents the overwhelming need for affordable housing in this country. The report found that in 1997, nearly 14 million families had a critical housing need, meaning that they either spent more than 50 percent of their incomes on housing or that they lived in a seriously substandard unit. Approximately 3 million of these households were "working families" earning between $10,700 -- the equivalent of a full-time, minimum wage job – and 120 percent of the local median income. Even more striking is the fact that more than half of these "working families" are homeowners.

We believe that in this time of severe housing need there is great demand for the types of financing and the financial stability the GSEs offer. For example, Fannie Mae, Freddie Mac and the Federal Home Loan Banks have all developed products specifically designed to enable working families to become homeowners at the least possible cost to the borrower. In addition, the GSEs also have pioneered products to supplement the development of affordable multifamily rental properties.

We are concerned about the instability that the current proceedings have interjected into the capital markets and the distraction from the critically important efforts of the GSEs that are so necessary to meet the nation's affordable housing crisis.

In closing, NHC urges the Subcommittee to consider a balanced view of the GSEs' position in the housing market. We also ask the Subcommittee to consider providing an opportunity for a range of participants from the housing industry to comment on the role GSEs should play in housing.

Sincerely,

Bob Reid

Robert J. Reid
Executive Director

A-HOUSE Program Alliance, Inc.

Affordable Home Ownership Using Support & Education
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Telephone (404) 653-9982
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June 14, 2000

The Honorable Paul Kanjorski
2353 Rayburn House Office Building
U.S. House of Representatives
Washington, DC 20515

Dear Representative Kanjorski:

I wanted to express to you my appreciation of the good work Fannie Mae continues to do to provide affordable housing opportunities within the Atlanta, Georgia marketplace. Here, Fannie Mae has experimented with new lending products which I am confident will demonstrate that it is possible to significantly increase home ownership without significantly increasing the financial risks to the investor or Fannie Mae. For example, programs, which focus more on rental payment history and less on consumer credit, opens the door to home ownership for lower income households. Other initiatives that allow buyers with credit problems to purchase at a higher interest rate, and then lowers the interest rate as buyers make their payments on time will dramatically increase homeownership among minorities and lower income families. For this forward thinking, I feel Fannie Mae ought to be applauded. Please bear this in mind when conducting your hearings this Thursday, June 15th before the House Banking Subcommittee.

Respectfully submitted,

Steven Holland
President

National Fair Housing Alliance

June 14, 2000

The Honorable Paul Kanjorski
2353 Rayburn House Office Building
U. S. House of Representatives
Washington, DC 20515

Dear Representative Kanjorski:

On Thursday, June 15th, the House Subcommittee on Capital Markets and Government Sponsored Enterprises is holding an oversight hearing on Fannie Mae and Freddie Mac. One of the key issues that the hearing will address is the regulation of Fannie Mae and Freddie Mac's movement into the subprime market. On behalf of the National Fair Housing Alliance, I write today to provide our perspective on this issue.

As numerous studies have shown, subprime lending has grown significantly in recent years providing underserved populations with access to credit. However, the rise in subprime lending has led to an increase in predatory lending behavior -- abusive lending practices targeted at the most vulnerable consumers. The victims of predatory lending are most often people of color and elderly homeowners.

I am convinced that public policy should support – not restrict – the ability of Fannie Mae to enter the subprime market. Their entry into this market will bring needed competition and standardization. Fannie Mae's entry in the subprime market will provide standards for underwriting and for servicing applicants with credit blemishes. In addition it will likely result in lower costs to consumers. Currently, there is no widely accepted definition of what factors place an applicant in the A-, B+ or B credit categories. As a result of this underwriting chaos, consumers are given a wide range of interest rates, fees and costs for subprime loans. Unfortunately, many people in this market fail to "shop around" for the best rates and do not contact conventional lenders who may help them secure a lower rate.

Furthermore, in order to effectively and efficiently investigate complaints of discrimination involving subprime and predatory lenders, it is extremely useful to have underwriting standards that are universally accepted. Such standards can be used to compare the terms and conditions of loans to applicants of color against similarly situated white applicants, or they can be used to compare the treatment of elderly applicants with non-elderly applicants.

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An added benefit of encouraging Fannie Mae to develop products and services for borrowers currently served by the subprime market will be a likely increase in lending by conventional primary market lenders in communities where predatory lenders often represent the only alternative. For example Fannie Mae's "Timely Payment Rewards" product represents a responsible and helpful approach to serving these consumers.

Thank you very much for your time and consideration of these views. It is my hope that this perspective can be made a part of the hearing record. If either the National Fair Housing Alliance or myself can be of future assistance please do not hesitate to contact us at your convenience.

Sincerely,

Shanna L. Smith
Executive Director

alhfa

ASSOCIATION OF LOCAL HOUSING FINANCE AGENCIES

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web site: www.alhfa.org

June 14, 2000

The Honorable Paul Kanjorski
Ranking Minority Member
House Subcommittee on Capital Markets, Securities
and Government Sponsored Enterprises
2353 Rayburn House Office Building
Washington, DC 20515

Dear Congressman Kanjorski:

In connection with hearings being held on June 15th before the House Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises on H.R. 3703, the "Housing Finance Regulatory Improvement Act," I wanted to advise you of the view of members of the Association of Local Housing Finance Agencies with respect to the role which Fannie Mae and Freddie Mac play in expanding affordable housing opportunities for low- and moderate-income Americans.

Both Fannie Mae and Freddie Mac are important partners with local housing finance agencies. For example, since 1987 Fannie Mae has purchased $5.694 billion in tax-exempt Mortgage Revenue Bonds issued by local housing finance agencies. These purchases have helped an estimated 95,000 families purchase their first home. Fannie and Freddie's purchase of these bonds on a private placement basis results in savings that local housing finance agencies can use to provide additional assistance to first-time homebuyers in the form of down payment and/or closing cost assistance.

Fannie Mae and Freddie Mac are key players in financing affordable housing. Their presence in the market has added value, and their presence has increased the homeownership rate through outreach to minorities and lower income families, while lowering mortgage cost to consumers.

I would appreciate your making this letter part of the record for this hearing.

Sincerely,

John C. Murphy

John C. Murphy
Executive Director

AFL • CIO
HOUSING
INVESTMENT
TRUST

June 14, 2000

JUN 15 2000

The Honorable Paul Kanjorski
2353 Rayburn House Office Building
U.S. House of Representatives
Washington, DC 20515

Dear Representative Kanjorski:

The House Banking subcommittee on Capital Markets and Government Sponsored Enterprises is holding a hearing on the Housing Finance Regulatory Improvement Act on June 15. Accountability and competition in this arena are certainly critical to the affordable housing industry and to the American taxpayers. It is also essential to recognize the important role the Government Sponsored Enterprises (GSEs) have played in providing us with the most efficient housing capital market in the world. Additionally, the role the GSEs play in promoting affordable housing initiatives is of critical concern to the subcommittee. From the perspective of the AFL-CIO Housing Investment Trust, Fannie Mae has been a superb partner in many of our housing initiatives.

The AFL-CIO Investment Program was created in 1964 as one of the nations first vehicles for the investment of pension funds in housing. Today, the AFL-CIO Housing Investment Trust manages $2.2 billion in net assets for 415 participating labor organizations and pension plans. In the 1990s, the Trust committed $2.7 billion in financing to support over 37,000 housing units in 224 union-built projects across the country. Each year, the Trust makes investments of some $500 million in multi-family and single-family housing. This secure investment fund earns competitive returns while generating employment, increasing housing supply and promoting local economic development.

The GSEs have provided the liquidity, credit enhancements and the securitization of mortgages to enable large amounts of pension capital to be invested in housing. In addition, the Trust has developed a number of partnerships with Fannie Mae to invest workers' pension funds into affordable housing that rebuilds communities, provides people with a decent home and enables many families to build equity through homeownership. Two examples of these partnerships are the multifamily Community Investment Demonstration Program ("CIDP" or "Program") and the single family Homeownership Opportunity Initiative.

1717 K Street, NW Suite 707 Washington, DC 20006 202/331-8055 Fax 202/331-8190

On October 6, 1993, Congress enacted the HUD Demonstration Act of 1993 which established certain programs to assist states and local communities in efforts to relieve homelessness, assist community development organizations and provide affordable rental housing. One of the programs authorized by the legislation was the CIDP. The legislation authorized the HUD Secretary to carry out a demonstration program to attract pension fund investment in affordable housing through the use of limited project-based Section 8 rental assistance. The AFL-CIO Housing Investment Trust in partnership with HUD, Fannie Mae, communities, nonprofits, state housing agencies and local government produced a number of significant accomplishments in implementing the CIDP including:

- $106 million in construction, permanent and bridge loans from the Trust invested in 18 affordable housing projects across the nation;
- Over 1970 units of affordable housing units built and rehabilitated, creating housing for more than 5,900 residents;
- $255 million provided in total project development costs.

In the CIDP, the Trust and Fannie Mae introduced a lending innovation, which enabled the project developer to minimize the risk to the project while providing deeper affordability for all of the units. Throughout the process of completing these 18 critical projects, Fannie Mae demonstrated the willingness and capacity to innovate to achieve affordable housing goals.

The Trust has also partnered with Fannie Mae on its Single Family program, including the Homeownership Opportunity Initiative. Fannie Mae has provided flexible guidelines and a reduction in mortgage insurance premium requirements on this Fannie 97 product. Over 65% of the participants in the Homeownership Opportunity Initiative are below 100% of Area Median Income and more than 70% live in central cities. The Trust is exploring additional single family partnerships with Fannie to address homeownership gaps, especially in central cities and among African Americans and Hispanic Americans.

The AFL-CIO Housing Investment Trust is pleased to provide any additional information on our partnership activities with Fannie Mae. We look forward to working with all of our affordable housing partners to ensure our housing finance system is responsive to the needs of America's communities.

Sincerely yours,

Stephen Coyle

SAN ANTONIO ALTERNATIVE HOUSING CORPORATION
Community Housing Development Organization
1215 S. Trinity
San Antonio, Texas 78207
210-224-2349
210-224-9686 (Fax)

June 14, 2000

The Honorable Paul Kanjorski
2353 Rayburn House Office Building
U.S. House of Representatives
Washington, DC 20515

Via Facsimile: 202-225-0764

Dear Representative Kanjorski:

I am writing to you to express my support for Fannie Mae and Freddie Mac. I realize that the Government Sponsored Enterprises Subcommittee of the House Banking Committee is holding a hearing on Thursday, June 15. San Antonio Alternative Housing Corporation has worked very closely with Fannie Mae over the past several years to create more opportunities for homeowners.

Fannie Mae provided critical capital needed to finance Logo Vista-a multifamily property of 92 units near West Side San Antonio. This is the first new construction multifamily property where rents are at market and affordable rates. In addition 15% of the units were dedicated for special needs population.

Please understand that Fannie Mae is vital partner in this community, and we look forward to working with them in the future.

Thank you for your help with this matter.

Sincerely,

Mark Luft

Mark Luft
Director of Construction & Development

PROJECT FOR PRIDE IN LIVING
2516 Chicago Avenue
Minneapolis, MN 55404
Phone: 874-8511 FAX 874-6444
e-mail: ppl@ppl-inc.org

Project for Pride in Living, Inc.

June 15, 2000

The Honorable Paul Kanjorski
2353 Rayburn House Office Building
U.S. House of Representatives
Washington, D.C. 20515

Dear Representative Kanjorski:

I understand that there will be hearings on June 15 before the House Banking Subcommittee on Capital Markets and Government Sponsored Enterprises on the Housing Finance Regulatory Improvement Act. I am contacting you because I would like to share our experiences with Fannie Mae.

I am director of Project for Pride in Living, non-profit housing organization that develops, manages, and owns properties in inner city communities in the Twin Cities. Fannie Mae has been a vital partner in helping to tackle some of our toughest housing problems. We have worked with the Minnesota Fannie Mae Partnership Office in a number of ventures including most recently, the redevelopment of two pivotal blocks in the heart of the Phillips neighborhood of Minneapolis. It is doubtful that we would have begun to turn this neighborhood without the technical and financial support of Fannie Mae.

We are continuing to work closely with Fannie Mae on a number of ventures here in the Twin Cities to help meet the critical affordable housing need and consider them one of our most valued partners. I felt it important that the hearing record recognize the tremendous contributions made here.

Sincerely,

Jim Scheibel

Jim Scheibel
President and Executive Director

OPPORTUNITY VILLAGE
6300 WEST OAKEY, LAS VEGAS, NV 89146
(702) 259-3700 · FAX: (702) 259-3734

June 14, 2000

The Honorable Paul Kanjorski
2353 Rayburn House Office Building
U. S. House of Representatives
Washington, DC 20515

Dear Representative Kanjorski:

I understand that hearings are being held on Thursday, June 15 before the House Banking Subcommittee on Capital Markets and Government Sponsored Enterprises, on the Housing Finance Regulatory Improvement Act. I believe that it's important for the Subcommittee to consider the views of organizations working to expand affordable housing opportunities.

I am Executive Director of Opportunity Village, a nonprofit organization in Southern Nevada. Opportunity Village exists to provide vocational training, employment and enrichment opportunities for individuals with mental retardation and related disabilities. We look at each individual we serve as a "whole" person and seek to enrich the quality of their lives. We are committed to ensuring the greatest possible social and economic independence for our clients and to fully integrate them into the community. Part of this commitment includes working to increase their opportunities to obtain affordable, accessible housing.

Opportunity Village and Fannie Mae have actively participated in the Nevada HomeChoice Coalition. This is a group that ensures the availability of affordable housing for the state's growing disabled community. Due in large part to Fannie Mae's HomeChoice Mortgage product, this Coalition has assisted over 25 disabled individuals to become homeowners. Fannie Mae initially committed $1 million to this experimental product, and has since included it as a standard product. Without Fannie Mae's active participation in this project, this accomplishment would not have been possible, and this underserved segment of the population would not have been addressed.

This is just one example of the contribution Fannie Mae makes to affordable housing and increasing homeownership in Nevada. As you can see, they are definitely part of the solution, not part of the problem. I think that it is very important that the hearing record recognize the contribution that Fannie Mae makes here in Nevada.

Sincerely,

Gerard Klote

Edward R. Guthrie for
Executive Director

OPPORTUNITIES, INC.

117 EAST FIRST STREET • P.O. BOX 569 • WATONGA, OK 73772 • 580-623-7283 • FAX 580-623-2515

GEORGIA M. FORTHUM
EXECUTIVE DIRECTOR

HEAD START

RSVP

HOME WEATHERIZATION

CSBG OUTREACH

FEMA

BEHAVORIAL CARE SERVICES & HALFWAY HOUSE

CACFP

VISTA

SEEDS

June 14, 2000

The Honorable Paul Kanjorski
2353 Rayburn House Office Building
U.S. House of Representatives
Washington, DC 20515

Dear Representative Kanjorski,

I feel it's very important for the Capital Markets and Government Sponsored Enterprises Subcommittee to know of all the great things that Fannie Mae and Freddie Mac are doing in our communities. I hope you consider this information during your hearing on June 15 to discuss the Housing Finance Regulatory Improvement Act. Several of the provisions in this bill would hinder the work we do with Fannie Mae and Freddie Mac.

Fannie Mae and Freddie Mac are very actively involved in our market to lower mortgage costs for the consumer. As a non-profit community action agency, we rely on the housing partnerships we have formed with Fannie Mae and Freddie Mac to assist us in meeting our mission. Examples of their work in rural northwestern Oklahoma include sponsoring educational Home Buyer Seminars, designing special mortgage products for our low-to-moderate-income clients in rural Oklahoma, sponsoring state of the art housing finance training for our housing staff, partnering with our local banks to provide special financing for affordable housing projects and providing leadership in solving our rural housing problems.

I look forward to many years of partnerships with Fannie Mae and Freddie Mac to increase the homeownership rate in Oklahoma.

I appreciate your help and support

Sincerely,

Georgia M. Forthum

Georgia M. Forthum, CCAP
Executive Director

"A COMMUNITY ACTION AGENCY"
PEOPLE HELPING PEOPLE

Congresswoman
Marge Roukema

Fifth District - New Jersey

2469 Rayburn House Office Building/Washington, D.C. 20515 (202) 225-4465

Contact:
J. Craig Shearman
(202) 225-4465

Release:
June 15, 2000

Roukema GSE Statement

Following is the opening statement of U.S. Congresswoman Marge Roukema, R-N.J.-5th, as prepared for delivery at today's hearing on government sponsored entities before the House Banking Committee's Subcommittee on Capital Markets.

Today marks the third hearing in three months on Mr. Baker's bill, H.R. 3703. This bill would consolidate the regulators of the housing GSEs – Fannie Mae, Freddie Mac and the Federal Home Loan Banks.

I will be brief.

These are serious oversight hearings and are very important. Mr. Baker has raised several issues which we need to explore carefully: potential systemic risk due to the size of the housing GSEs, appropriate capital requirements, bank ownership of Agency securities and possible concentration problems.

At the last hearing I made it clear that I am very concerned about allegations of mission creep. Congress created these GSEs to address a specific problem that the private sector could not address. They should not get into activities — real estate brokerage, mortgage insurance and consumer lending — that are beyond their specific charters. I want to congratulate Mr. Baker on undertaking such a serious subject. He has embarked on what will probably be an extended process.

I want to make it clear, however, that while I endorse these oversight hearings, moving this legislation is another matter. I — as well as several other members — do not support moving this legislation forward this year. Mr. Chairman, I believe you agreed to this at the previous hearings. I am concerned by press reports that you may be considering trying to move this bill out of Subcommittee. Quick action on this would be ill advised.

All of us are for the American dream of home ownership. Based on this we must look at and understand all the potential effects — especially the negative effects — H.R. 3703 might have on home ownership before we move forward. We must be diligent and avoid the dangers of unintended consequences. None of us want to increase the cost of home ownership, even inadvertently. While today's witnesses believe that change is necessary, they disagree on what those changes should be. Just one example can be found on the issue of the Treasury credit lines. H.R. 3703 would eliminate the credit lines. Mr. Taylor supports continuation of the credit line if Fannie and Freddie meet their housing goals. Another example would be the one regulator. Some want it to be in HUD, others want the Federal Reserve to undertake the function and still others support the approach in your bill. Quite frankly, there is no consensus on what to do, if anything. I would submit that moving very slowly in this area is extremely important since we are talking about home ownership. None of us, even you, Mr. Chairman, can afford to be wrong on this

issue. Again, beware of the dangers of unintended consequences.

We also need to keep things in perspective. Home ownership is at an all time high — 67 percent. The bottom line is that the housing GSEs have done a great job. Fannie, Freddie and the FHL banks have helped make — in partnership with the banks and mortgage companies — the American Dream a reality for more Americans than ever. And despite what some of the critics have said, they have a superb record on buying the home loans of low and moderate income Americans as well as minorities. Every year Fannie and Freddie have exceeded the goals HUD has set for them. Fannie and Freddie have adopted guidelines that prohibit the purchase of "predatory loans". I put these guidelines in the record at the last hearing, and I ask unanimous consent for inclusion of these guidelines in this hearing record today.

Just one further note, I was involved in the 1992 conference where the new capital standards for Fannie Mae and Freddie Mac were established. The S&L crisis was fresh in my mind. I think we did a very good job on the capital requirements for Fannie and Freddie. Fannie has $18 billion — that's right, $18 billion — in capital itself, while Freddie has several billion also. They have the 10-year stress-testing requirement, which is extremely rigorous. Very few banks or savings and loans could meet the requirements which Fannie and Freddie meet. They are in very good shape financially and I think that some of the suggestions to the contrary are not fair.

FannieMae

Anti-Predatory Lending Guidelines

Fannie Mae has long been concerned about predatory or abusive lending practices that can have negative consequences for homebuyers. As the company expands the availability of lower-cost mortgage products to borrowers with blemished credit histories and limited savings, Fannie Mae has established it's anti-predatory lending policies for the loans it buys from lenders. To help protect consumers from abusive lending practices, Fannie Mae developed the following guidelines.

- **Steering** -- For loans delivered to Fannie Mae, the company expects that lenders will have determined the borrower's ability and willingness to repay the mortgage debt regardless of the underwriting method the lender uses. In addition, lenders should have practices and procedures to offer mortgage applicants the full range of products for which they qualify, and should specifically avoid the steering of borrowers to high cost products that are designed for less creditworthy borrowers if the applicants can qualify for lower-cost products. Similarly, consumers that seek financing through a lender's higher priced subprime lending channel should be offered (or directed to) the lender's standard mortgage products if they are able to qualify for one of the standard products.

- **Excessive Fees** -- Lenders should have their own guidelines and policies that address the fees that originators and brokers can charge a borrower when a mortgage is originated and should apply those policies consistently. For loans delivered to Fannie Mae, the points and fees charged to a borrower should not exceed 5 percent, except where this would result in an unprofitable origination (for example, because of the small size of the loan). In addition, we will not purchase a mortgage that is subject to the requirements in the Home Ownership and Equity Protection Act of 1994 (HOEPA) that apply to "high cost" mortgages.

- **Prepaid Single Premium Credit Insurance Policies** -- Fannie Mae will not purchase or securitize any mortgage for which a prepaid single-premium credit life insurance policy was sold to the borrower in connection with the origination of the mortgage loan, regardless of whether the premium is financed in the mortgage amount or paid from the borrower's funds. This does not apply to credit life insurance policies that require separately identified premium payments on a monthly or annual basis or to prepaid hazard, flood, or mortgage insurance policies.

- **Prepayment Penalties** -- Fannie Mae will only consider allowing prepayment penalties under the terms of a negotiated contract, and where the lender adheres to the following credit criteria: a mortgage that has a prepayment penalty should provide some benefit to the borrower (such as a rate or fee reduction for accepting the prepayment premium); the borrower also should be offered the choice of another mortgage product that does not require payment of such a premium; the terms of the mortgage provision that requires a prepayment penalty should be adequately disclosed to the borrower; and, the prepayment penalty should not be charged when the mortgage debt is accelerated as the result of the borrower's default in making his or her mortgage payments.

- **Full-file Credit Reporting --** Fannie Mae believes that it is important for a borrower's entire payment history to be reported to the credit repositories since that gives a borrower who has a good payment record more opportunities to obtain new financing (and better mortgage terms) when the need arises. Therefore, the company restated its policy that lenders must report on the status of any Fannie Mae loan that they are servicing each month to the credit repositories.

- **Servicing Practices --** Fannie Mae generally requires servicers to maintain escrow deposit accounts for the monthly deposit of funds to pay taxes, ground rents, mortgage insurance premiums, etc. In some cases, the company will allow its servicers to waive the requirement on a case-by-case basis. However, the company suggested that waivers should not be granted in the case of borrowers with blemished credit records to protect them from additional risk of default.

Fannie Mae helps make sure mortgage money is available for people in communities all across America. Fannie Mae does not lend you money directly. Instead, Fannie Mae works with lenders to make sure they don't run out of mortgage funds, so more people can achieve the dream of homeownership.

Date: April 11, 2000

To: All Fannie Mae Sellers

Subject: LL03-00: Eligibility of Mortgages to Borrowers with Blemished Credit Records

Last month, Fannie Mae announced the American Dream Commitment -- our commitment to provide $2 trillion in financing to serve 18 million targeted families by the end of the decade. Our goal is to work with our lending and community development partners to reduce consumer costs, break down barriers to homeownership, and serve as a catalyst in the revitalization of cities, towns, and neighborhoods. An important component of this goal is to expand the availability of lower-cost mortgage products to consumers who have blemished credit histories and limited savings. Historically, many of these families have relied on the subprime market to meet their financing needs. While many families have been well served by that market, far too many have had to pay higher costs than necessary and, even worse, have experienced abusive lending practices.

Some of the practices that fall under the umbrella of abusive (or "predatory") lending include (among other things): "steering" a borrower toward a mortgage with a higher interest rate and/or fees even when the borrower could qualify under a less costly financing alternative; approving a mortgage based solely on the value of the property without considering whether the borrower has the ability to repay the debt (which could result in the borrower's losing his or her home); multiple refinancings of a mortgage without any real economic benefit to the borrower (for example, a refinancing that has no appreciable effect on the mortgage interest rate, payments or term, but which results in the borrower's having to pay another round of fees that worsen his or her financial position); charging excessive fees and points (which can result in the "stripping" away of the borrower's equity in the property); failing to disclose prepayment premiums to the borrower or using them as a method to prevent a victim of "steering" from being able to refinance to a lower-rate mortgage; and charging a higher rate of interest after a mortgage goes into default.

In recent years, the mortgage finance industry has achieved some significant accomplishments in serving American homebuyers, raising the U.S. homeownership rate to the highest level ever. We are proud of the contributions that we and our lenders have made toward the achievement of the record level of homeownership. Fannie Mae's innovations in technology and mortgage product design and in the financial markets have helped lenders make it possible to lower the costs of homeownership. The prudent, sound, and responsible business practices that our lenders use in their marketing, origination, and servicing efforts helped to make this achievement possible. As we begin to do more to lower costs for consumers who have blemished credit histories, we want to make sure that those individuals benefit from these same kinds of business

practices. We believe that our lenders will join with us in identifying and avoiding the abusive lending practices that a small number of lenders in the subprime market have been using. Toward that end, we are releasing this letter to make sure that all lenders will be aware of Fannie Mae's guidelines for purchasing mortgages made to borrowers who have blemished credit histories.

We welcome and encourage more industry discussions about the best measures for preventing predatory lending practices. We will continue such discussions with our customers so we can take advantage of what they have learned through their own particular operations and overall practices. We will use the information gained through these discussions and our own experience as we go forward as the basis for making appropriate adjustments to our guidelines.

Expanded Approval Mortgage Products

Fannie Mae currently offers through Desktop Underwriter® two products that are designed to assist individuals who have had difficulty in managing their credit -- the Expanded Approval mortgage and the Timely Payment Rewards mortgage. A borrower who is recommended for approval for either an Expanded Approval mortgage or a Timely Payment Rewards mortgage is eligible for an initial mortgage interest rate that is less than the rate that is currently available for subprime loans, albeit higher than the rates offered to borrowers who have better credit. In addition, with a Timely Payment Rewards mortgage, the borrower's interest rate will automatically be reduced after he or she makes timely payments on the mortgage for 24 consecutive months, thus eliminating the time and costs involved in a typical refinancing. Neither of these mortgages requires a prepayment premium in connection with an early payoff or a refinancing of the mortgage. Many borrowers who, in the past, would have had to obtain mortgages through the subprime market can now qualify for lower-cost mortgages as the result of these new mortgage offerings.

As we make the Expanded Approval mortgage and the Timely Payment Rewards mortgage available more widely, develop additional products for borrowers who have blemished credit histories, and otherwise expand our purchases of mortgages made to these borrowers, Desktop Underwriter's consideration of the borrower's ability to repay the debt will be one of the key components for evaluating the eligibility of individual mortgages for delivery to us. We believe that this approach in conjunction with other guidance included in this letter are important factors in avoiding predatory lending practices for mortgages that are sold to Fannie Mae.

We will also consider purchasing mortgages that are evaluated based on a lender's own underwriting criteria (which may or may not include an automated underwriting system). When a lender's underwriting criteria are used -- and those criteria include higher pricing to compensate for the increased risk of borrowers who have blemished credit histories -- we will consider purchasing such mortgages only if the lender's business practices support the principles discussed in this letter.

Product Steering

Lenders that offer higher cost products that are designed for less creditworthy borrowers should not steer applicants to these products if they can qualify for a lower-cost standard mortgage product. Similarly, a consumer that seeks financing through a lender's higher-priced subprime lending channel should be offered (or directed toward) the lender's standard mortgage product line if he or she is able to qualify for one of the standard products.

Fannie Mae is using Desktop Underwriter to help lenders expand the products they offer to borrowers who have blemished credit histories. Desktop Underwriter will recommend approval of a mortgage with a credit-risk pricing adjustment only if such an adjustment is warranted after a comprehensive assessment of all of the risk factors present in the loan application. In fact, Desktop Underwriter recommends for approval many applicants who have slightly impaired credit without requiring a credit-risk pricing adjustment.

Borrower's Ability to Make Mortgage Payments

Fannie Mae has always relied on the lender's determination that the borrower has a reasonable ability and likelihood of repaying the debt for any mortgage that the lender sells to us. Regardless of the underwriting method the lender uses, the lender's underwriting of the mortgage confirms that, at the time of loan origination, the borrower can afford to make the mortgage payments. This determination of the borrower's ability to repay is reached by relating the borrower's income, assets, and liabilities to the proposed mortgage payment.

Our willingness to purchase mortgages made to borrowers who have blemished credit histories, notwithstanding their higher credit risk, is still predicated on the use of underwriting standards (either Fannie Mae's or the lender's) that confirm that the borrower has a reasonable ability to make the mortgage payments and is likely to do so in a manner that will enable him or her to successfully maintain homeownership.

Allowable Points and Fees

Lenders generally have guidelines and policies that address the fees that originators and brokers can charge a borrower when a mortgage is originated. Fannie Mae's guidelines with respect to the points and fees that a borrower can be charged for a mortgage that will be sold to Fannie Mae are discussed below.

Mortgages are not eligible for purchase by Fannie Mae if the total points and fees charged to the borrower are greater than 5% of the mortgage amount, except when this limitation would result in an unprofitable origination for the lender (for example, because of the small size of the mortgage). Under this guideline, points and fees include origination fees, underwriting fees, broker fees, finder's fees, and charges that the lender imposes as a condition of making the loan -- whether they are paid to the lender or a third party. Points and fees that do not have to be counted against this limitation include *bona fide* discount points, as well as fees paid for actual services rendered in connection with the origination of the mortgage, such as: attorneys' fees, notary's fees, and fees paid for

property appraisals, credit reports, surveys, title examinations and extracts, flood and tax certifications, and home inspections; the cost of mortgage insurance or credit-risk price adjustments; the costs of title, hazard, and flood insurance policies; state and local transfer taxes or fees; escrow deposits for the future payment of taxes and insurance premiums; and other miscellaneous fees and charges that, in total, do not exceed 0.25% of the loan amount.

In addition, a mortgage is not eligible for purchase by Fannie Mae if it is subject to the requirements in the Home Ownership and Equity Protection Act of 1994 that apply to "high-cost" mortgages.

Single-Premium Credit Life Insurance Policies

Credit life insurance policies are life insurance policies that a borrower may purchase to provide benefits that can be applied toward the repayment of a mortgage loan should the borrower die before the loan is paid off. Although some borrowers choose to obtain credit life insurance policies, no borrower should be required to purchase such policies as a condition of obtaining a mortgage.

A mortgage is not eligible for purchase by Fannie Mae if the borrower obtained a prepaid single-premium credit life insurance policy in connection with the origination of the mortgage, regardless of whether the premium is financed in the mortgage amount or paid from the borrower's funds. This prohibition does not apply to credit life insurance policies that require separately identified premium payments on a monthly or annual basis or to prepaid hazard, flood, or mortgage insurance policies.

Prepayment Premiums

Sometimes, a borrower who wants a lower monthly payment or lower closing costs may agree to accept a mortgage that includes a prepayment premium in connection with an early pay off of the mortgage. Fannie Mae announced in 1994 (see Announcement 94-07) that we would purchase mortgages that called for prepayment premiums only under the terms of a negotiated contract (although our Announcement did not specify the criteria we use to determine if a requested commitment is acceptable). We expect a lender to take the following Fannie Mae requirements into consideration when requesting a commitment to cover the delivery of mortgages that provide for the charging of prepayment premiums:

- A mortgage that has a prepayment premium should provide some benefit to the borrower (such as a rate or fee reduction for accepting the prepayment premium). The borrower should also be offered the choice of another mortgage product that does not require payment of such a premium.

- The terms of the mortgage provision that requires a prepayment premium should be adequately disclosed to the borrower.

- The prepayment premium should not be charged when the mortgage debt is accelerated as the result of the borrower's default in making his or her mortgage payments.

Full-File Reporting to Credit Repositories

A key factor that affects a borrower's credit record is the amount of information that the credit repositories have on hand about the borrower's payment history. Some lenders in the subprime market do not report a borrower's payment history to the credit repositories or may report only when payments are delinquent. We believe that it is important for a borrower's entire payment history to be reported to the credit repositories since that gives a borrower who has a good payment record more opportunities to obtain new financing (and better mortgage terms) when the need arises.

To assure that the credit repositories have up-to-date information about both servicing and origination activity, we began requiring in March, 1996 full-file credit reporting for all Fannie Mae-owned or -securitized mortgages. As stated in Announcement 95-19, lenders should make sure that they report one of the following statuses each month for each mortgage that they are servicing for Fannie Mae -- new origination, current, delinquent (30-, 60-, 90-days, etc.), foreclosed, or charged-off.

Escrow Deposit Accounts

Fannie Mae generally requires servicers to maintain escrow deposit accounts for the monthly deposit of funds to pay taxes, ground rents, mortgage insurance premiums, and hazard and flood insurance premiums, as long as state law does not prohibit the establishment of an escrow deposit account for the mortgage. This protects the borrower from having to pay large annual or semi-annual tax payments or insurance premiums in a lump-sum when they come due, which is particularly important when the borrower has not appropriately budgeted for these payments. We understand that some of the multiple refinancings that take place are attributable to the fact that the borrower initially was not required to have an escrow deposit account and subsequently could not come up with the funds needed to make the property tax payment, thus creating the need for a higher balance refinance mortgage to obtain the funds. While servicers may waive the requirement for an escrow deposit account on a case-by-case basis, we suggest that such waivers not be granted to borrowers who have blemished credit histories and few cash reserves since these borrowers may have difficulties in making the required tax and insurance payments in a lump-sum.

*****

We will use the guidelines discussed in this letter as we work with more lenders to develop lower-cost mortgage products for borrowers who have blemished credit histories to make sure that we avoid purchasing mortgages that involve abusive lending practices. Based on the discussions we had with lenders and others in our development of these guidelines, we understand fully that it is difficult (and somewhat subjective) to establish specific definitions and/or limits to address the reasonableness and appropriateness of various lending costs, products, or practices. Nonetheless, as we increase our efforts to

lower mortgage costs for consumers who have blemished credit histories, we feel that it is important that we make it clear what Fannie Mae intends to do to avoid predatory lending practices.

We recognize that many lenders that serve borrowers who have blemished credit histories already have in place policies and procedures that are designed to avoid the practices noted in this letter, although they may not capture in their management information systems complete information for every mortgage. For example, lenders may not have available for each and every mortgage information about the total points and fees charged to the borrower or whether or not the borrower has chosen to purchase credit life insurance (and, if so, how the premium is paid). In view of this, we will work with lenders, as we both do more to serve borrowers who have blemished credit histories, to put into place appropriate measures to ensure that predatory lending practices are avoided.

Lenders should contact their Customer Account Manager in their lead Fannie Mae regional office if they have any questions about the material discussed in this letter or want to discuss the appropriateness of specific business practices.

Robert J. Engelstad
Senior Vice President

Congressman John E. Sweeney
Committee on Banking and Financial Services
Hearing on H.R. 3703, Housing Finance Regulatory Improvement Act of 2000
June 15, 1999

Thank you , Mr. Chairman for holding another hearing on the Housing Finance Regulatory Improvement Act of 2000.

This is an enormously complex and sensitive issue, and as a freshman Member of this Committee, I found the testimony of the previous hearings quite enlightening. That information, combined with the Fannie Mae letter writing campaign on this issue, has certainly made me look carefully at this issue. There are still some outstanding issues from that hearing which must be addressed as soon as feasible.

Given current estimates that the GSE's $1.4 trillion of outstanding debt will surpass the United States Treasury debt by 2003, this matter must be given our serious attention. I believe this is a good point in time to examine the potential systemic risk these entities may pose to our financial system. I believe our charter is to keep tabs on the risk GSEs assume, as increased risk could equate to significant losses should our economy cool down.

Conversely, our nation's housing finance system is the envy of the world and now provides Americans with greater access to home financing than at any point in history. Some of that success must be attributed to the contributions of the GSE's to the secondary mortgage. I believe we must move with caution to ensure our actions do not upset the current boom in homeownership.

I want to make it clear that I am committed to taking action which is best for my constituents and the American people. I am certainly wary of any undertaking which would burden the mortgage marketplace with unnecessary regulations and discourage hard working Americans from realizing the joys of homeownership. Our goal must be to encourage more Americans to transform the dream of homeownership into a reality.

I look forward to hearing the opinions of the witnesses called before the subcommittee today. I am interested in hearing their view on what the impact of this legislation will be on the citizens of my Upstate New York Congressional District.

Thank you, again, Mr. Baker, for holding this important hearing.

65-224 00 - 8

TESTIMONY OF RALPH NADER

ON H.R. 3703
THE HOUSING FINANCE REGULATORY IMPROVEMENT ACT

SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES AND GOVERNMENT SPONSORED ENTERPRISES
JUNE 15, 2000

Mr. Chairman, thank you for inviting me. I welcome this opportunity to comment on your effort to upgrade the oversight and regulation of the three government sponsored enterprises which dominate the housing finance markets.

While there are clear differences between the thrift industry and the GSEs, HR 3703 is a reminder of what Congress failed to do to protect the taxpayers and the savings and loans a quarter of a century ago.

For years, this Committee and its companion Banking Committee in the Senate handled the savings and loan industry with soft kid gloves. The Federal Home Loan Bank Board, a pale imitation of a regulatory agency, was allowed to carry out its functions more as a cheerleader, than a regulator of financial institutions.

When the savings and loans began to fall apart in the 1980s, it was politically difficult to impose stringent regulations and higher capital standards on a struggling industry. Only after the

failures caused staggering multi-billion dollar losses to deposit insurance and taxpayer funds did the Congress reform the regulatory machinery, raise examination standards and establish mandatory criteria to trigger an early warning system and require prompt corrective action.

Looking back at this episode, historians will wonder how the Congress could have failed to establish these protections long before the disasters of the 1980s. Some Members of Congress obviously were too chummy with industry and too willing to look the other way when the speculators and quick-buck artists moved into the industry.

But others honestly viewed savings and loans as the primary source of funds critical to the production of badly needed housing in their districts. Tough oversight and strong regulation, these Members feared, would damage the industry and dry up mortgage funds. Of course, the savings and loans were quite happy to use this line as a defense against what few reformers ventured forth in the Congress.

In the end, this "see no evil, hear no evil and speak no evil" approach to oversight and regulation left the thrift industry a near wasteland and the taxpayers an estimated half a trillion dollars poorer.

Today, the housing GSEs and their supporters are borrowing pages from the old savings and loan manuals to slow reforms. Any suggestion for change in the high-flying life style of Fannie Mae, Freddie Mac or the Federal Home Loan Banks invariably elicits an immediate

bombardment of charges from the GSEs that proponents of reform are destroying the great American dream of home ownership.

"It's a tax on home ownership," is the favorite cliche of Fannie Mae in response to even the mildest proposal for reform. Congress needs to look beyond such facile anemic defenses.

For too long the Congress has played the role of an indulgent parent to the GSEs. The GSEs have long since grown beyond adolescence. It is time for GSEs to give up ties to the federal government that have made them poster children for corporate welfare. Most of all, Congress needs to look more to the protection of the taxpayers, and less to the hyperbole of the of the GSE lobbyists that form a standing army on Capitol Hill.

The housing-finance GSEs were born as creatures of the federal government and have evolved as hybrid enterprises where much of the risk remains with the government and the taxpayers while the profits flow to private shareholders.

Chairman Baker's bill–HR 3703–takes a big step toward providing a more rational and stronger regulatory system and removing some of the more obvious subsidies to the GSEs.

HR 3703 creates a five-member full-time Presidentially-appointed Housing Finance Oversight Board as an independent agency and consolidates all regulatory authority for the GSEs under that Board. This will eliminate the three separate agencies–Office of Federal Housing

Oversight (OFHEO), the Federal Housing Finance Board (FHFB) and the Secretary of Housing and Urban Development–which currently share supervision of the housing GSEs.

The establishment of a single regulator for the housing GSEs tracks the 1997 recommendations of the General Accounting Office (GAO). It will provide greater focus and consistency on oversight and safety and soundness of the housing GSEs than is possible in the present scattered system. The board will include the Secretary of the Treasury, the Secretary of HUD and three citizen members.

When this Committee was considering the so-called financial modernization legislation during the last three Congresses, I urged the same type of consolidation of the separate agencies that regulate depository institutions. The proposal got nowhere. I hope the fate of supervision of the GSEs fares better.

There is one modification, however, that I would urge for the single agency approach to the housing GSEs. I would strongly recommend that the Department of Housing and Urban Development continue to analyze and establish housing goals and transmit them to the independent board established under this legislation for enforcement.

HUD remains the federal government's expert on housing needs and this expertise should be utilized beyond the provision that the HUD Secretary be a member of the new board. Just as important, the legislation clearly focuses the board's attention on safety and soundness and this

focus needs to be maintained while HUD continues to provide the expertise on housing goals.

The legislation should also include provisions that will require ongoing disclosure of data by the housing GSEs that will provide specific information to enable the Board and the public to track the geographical location, race, gender and income levels of the homeowners whose mortgages are purchased by the GSEs. This should be disclosed by census tract.

In addition, the Board should be subject explicitly to the Freedom of Information Act (FOIA) and the Sunshine Act requiring open meetings.

In an obvious effort to overcome the money problems that have hampered the operations of OFHEO, the bill provides for the Board to be financed through assessments on the GSEs for "reasonable costs and expenses" without being subject to the appropriations process. I have misgivings about any federal agency escaping the appropriations process, but I recognize that OFHEO has special problems with the current process—problems that affect its ability to carry out its responsibilities.

OFHEO, as the safety and soundness regulator of Fannie Mae and Freddie Mac, is forced to battle continually to hang on to its meager budget. Earlier this month, an appropriations subcommittee whacked nearly five million dollars from OFHEO's request for $26.7 million budget. That means fewer examiners and financial experts to track Fannie and Freddie's far

flung empires.

In pleading for his budget, Armando Falcon, the Director of OFHEO, pointed out that his agency is trying to examine enterprises that own or guarantee two trillion dollars of residential mortgages.

To cut the budget of an agency trying to cope with these mammoth financial institutions is an outrage—a slap at the taxpayers who, unfortunately, bear the ultimate risk. Where are the investigative reporters who should be trying to find out what's going on in the House Appropriations Committee? Is this the result of more of the ham-handed lobbying by Fannie and Freddie to limit scrutiny of their operations?

OFHEO's budget problems are a prime example of why the reforms in the Baker bill are badly needed now.

Not only do the GSEs dominate the mortgage markets, but they have a huge share of the U. S. debt market. As Chairman Baker has pointed out in these hearings, the GSE debt of 1.4 trillion combined with GSE-guaranteed mortgage-backed securities of $1.2 trillion nearly total the $2.7 trillion of outstanding privately held marketable Treasury debt. Treasury Department estimates that the GSE debt may double to $3 trillion by 2005 and surpass the Treasury debt in three years.

We are obviously not talking about GSEs interested only in providing the American dream of home ownership, as their national advertising campaigns suggest. They have a big appetite that grows bigger as they saturate the mortgage market. They will reach out for more to maintain their high level of profits and shareholder dividends.. HR 3702 wisely gives the Oversight Board the duty of reviewing and limiting activities that go outside the GSEs mandate.

A lot of Fannie and Freddie's profits come from their links with the federal government which they retained after becoming a "private" shareholder corporation. These ties to the government have given the GSEs great benefits in the marketplace. As a result of these benefits, the GSEs are able to borrow in the market at interest rates very close to that enjoyed by the federal government, itself.

A study by the Congressional Budget Office estimated that 40 percent of the earnings of Fannie and Freddie in some years could be traced to the benefits of their government sponsored status. Even Alan Greenspan, Chairman of the Federal Reserve Board has chimed in with criticisms of the subsidies that pad the GSEs bottom lines.

The GSEs defend this largesse with the claim that the subsidy is passed on to homebuyers. CBO's studies debunk that claim. CBO says at least a third of the subsidy is pocketed by private shareholders, the corporations' executives and lobbyists.

HR 3703 eliminates one of the more egregious forms of corporate welfare–a standby line

of credit that could be drawn from the Treasury if the GSEs fell on bad times. Fannie and Freddie each have a $2.25 billion contingency fund at Treasury and the Federal Home Loan Banks a $4 billion line of credit.

But, other benefits remain including the exemption from local and state income taxes. Even when the District of Columbia was struggling on the edge of bankruptcy, Fannie Mae refused to cough up a dollar in lieu of the $300 million in taxes they escape annually through the exemption.

In addition, the securities of Fannie and Freddie are government securities for the purposes of the Securities and Exchange Act of 1934 and are exempt from registration. Their securities serve as eligible collateral for Federal Reserve banks' discount loans and the Federal Reserve serves as fiscal agent for the issues. In addition, the Secretary of the Treasury approves the issues.

The obligations are also eligible for unlimited investments by national banks and state bank members of the Federal Reserve as well as federally insured thrifts.

All these links are evidence in the eyes of the market that the federal government would rush to bail out the GSEs if they were in serious financial trouble. The market looks on these as fail-safe entities.

Chairman Baker has expressed concern about the fact that GSE debt has become a significant part of the assets of the banking system--an estimated $210 billion at mid-year 1999. National banks may invest no more than 10 percent of their capital in corporate bonds of one issuer. But because of the special GSE provision that I noted earlier, bank investments in GSE debt securities are not limited.

HR 3703 calls for a study by the Federal Deposit Insurance Corporation of the impact that a GSE failure would have on the solvency of the banks. It is important that this study goes forward.

Clearly, the special status of the GSEs has provided lucrative benefits for its executives. *The National Mortgage News* in an article headlined "Who Wants to be a GSE Millionare" recently combed through Fannie and Freddie's proxy statements and came up with these figures on the top executives for 1999:

At Fannie Mae:

1. Franklin Raines, Chairman, $2,370,007 including base salary, bonuses plus $1,329,448 in long-term compensation pay outs in 1999.

2. Lawrence Small, President, $1,982,259 (Small retired in 1999)

3. Jamie Gorelick, Vice Chair, $1,443,978.

4. Tim Howard, Executive Vice President, $933,300.

5. Rob Levin, Executive Vice President, $933,300.

At Freddie Mac:

1. Leland Brendsel, Chairman, $1,405,000 (less than Fannie Mase's Vice Chair, Jamie Gorelick.)

2. David Glenn, President, $910,000.

While the executives may be doing well, there are major questions about the adequacy of the GSE's support for housing in low and moderate income and minority neighborhoods.

An analysis of 1998 data conducted by Jonathan Brown of Essential Information indicates that in many MSAs the GSE market share of 1 to 4 family mortgage loans in low and moderate income and minority neighborhoods was only one-half the GSE market share of such loans in upscale non-minority neighborhoods.

Another study conducted by the National Community Reinvestment Coalition says that

Fannie and Freddie lag behind banks in financing single-family mortgages for minorities and low and moderate income homebuyers. That study, based on 1995 and 1996 data, found that only 32 percent of Freddie's and 33 percent of Fannie's loan purchases involved single family mortgages for low and moderate income homebuyers. In contrast, the study said 41 percent of - banks' single family loans went to such borrowers.

The emphasis in HR 3703 is on safety and soundness. This is a very important emphasis. But this Committee also needs to do more to examine the adequacy of the housing goals and the performance of the GSEs on affordable housing in low and moderate income and minority neighborhoods.

The regulatory improvements mandated by HR 3703 should be adopted by the Congress this session. They are long overdue and there is no reason to delay these taxpayer protections longer.

As this Committee proved in the enactment of reforms in the wake of the savings and loan debacle, bi-partisan coalitions can be formed successfully on safety and soundness issues and the oversight of federal regulation. That should happen now while the GSEs are prosperous, not when the fortunes of these institutions are sagging.

Some Members may feel that these institutions are so strong and so wealthy that there is no need for the protections incorporated in HR 3703. They see no possibility of downturns in

their fortunes. But this ignores history. Few foresaw the collapse of the savings and loan industry. Even fewer believed tax money would be used to bail out insured institutions. But it happened. And the regulators, and for that matter the whole nation, were poorly prepared for the disaster.

Fannie Mae has had its own downsides. In the early 1980s, for example, Fannie was technically insolvent on a market to market basis and was losing money at the rate of a million dollars a day.

Congress should act on this legislation while the sun is shining.

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Reform of GSE Housing Goals

Jonathan Brown, Essential Information

AEI Conference on Fannie Mae and Freddie Mac

May 23, 2000

HUD's proposed housing goal rules for Fannie Mae and Freddie Mac (the GSEs) and the many public announcements of Fannie Mae and Freddie Mac on their housing committments have fostered the general impression that the GSE housing goals have been a success, although some adjustments are needed to strengthen the goals. Looked at from a local community reinvestment perspective and a broad civil rights perspective, however, there are major problems in the implementation of the GSE housing goals. In our view, these problems stem in large part from serious flaws in the structure of the goals.

Our conclusion is based on an extensive review of GSE performance in individual metro areas (MSAs) across the nation. This review indicates that in many MSAs in 1998 the GSE market share of 1-4 family mortgage loans in low and moderate income and minority neighborhoods was roughly one-half the GSE market share of such loans in upscale, non-minority neighborhoods.

In conducting this analysis, we measured GSE market share as the ratio between Fannie Mae and Freddie Mac's combined purchases of 1-4 family mortgages and the total number of conventional 1-4 family mortgage loan originations reported under HMDA with loan amounts below $227,000 -- the 1998 GSE loan amount ceiling for mortgages on 1-unit homes. GSE purchases are based on the Census Tract File in the GSE Public Use Database. This file does not distinguish between home purchase loans and refinancing loans, so we consolidated these two types of mortgage loans in computing GSE market shares.

Implicit in the GSE housing goal concept is the idea that the GSEs should, at minimum, support the mortgage market in low and moderate income and minority neighborhoods to the same extent that they support the mortgage market in affluent, non-minority neighborhoods. Clearly, this minimum standard of support is not being met where the GSE market share of mortgage loans in low and moderate income or minority neighborhoods is much less than the GSE market share in affluent or non-minority neighborhoods. Similarly, the GSEs fall short of this minimum standard when the GSE market share of mortgage loans to low or moderate income or minority borrowers is well below the GSE market share of loans to more affluent or non-minority borrowers.

Attached are four maps that provide stark examples of how the GSE market share tends to decline sharply in inner-city neighborhoods. The 1998 Chicago, Cleveland, and Akron maps were submitted to HUD pursuant to the pending rulemaking on GSE housing goals by Illinois ACORN and the Metropolitan Strategy Group of Ohio. The 1996 Chicago map was presented

by Essential Information at a 1998 conference on the role of the GSEs.

The maps contain a diagonal overlay to identify minority census tracts. In the case of the Chicago maps, the diagonal overlay identifies census tracts in which non-White and non-Asian persons comprise 70% or more of the census tract population. In the Cleveland and Akron maps, the diagonal overlay indicates census tracts in which minority persons comprise 40 % or more of the census tract population. As shown in the maps, there is a very strong correlation between the racial composition of census tracts and the GSE market share. Also, comparison of the 1996 and 1998 Chicago maps show that the overall pattern of GSE market share disparity did not changed very much during this two-year period.

To provide further insight into the nature of GSE housing goal performance in the Chicago PMSA, we prepared a set of statistical tables on 1998 GSE market shares by census tract race and income categories and by borrower race and income categories. These tables are based on GSE loan purchase data and HMDA loan origination data for the nine-county Chicago PMSA.

Table 1 provides GSE market share data by census tract racial category. Table 1 shows a decline in GSE market share from 75.10% in predominantly non-minority census tracts to only 33.28% in census tracts in which minorities comprise 75% or more of the census tract population. In the Chicago PMSA, these two census tract categories represent almost 60% of the PMSA's total of 1,776 census tracts.

Table 2 provides GSE market share data by census tract income category. This table shows a decline in GSE market share from 77.54% in upper income census tracts to only 39.01% in low income census tracts. The census tract income related decline in GSE market share shown in Table 2 is similar to the census tract race related decline shown in Table 1, except that not as many census tracts are pushed down to the lowest market share interval. This is consistent with our general experience that a sharper focus on GSE market share disparities can often be obtained by looking at census tract race rather than census tract income.

Table 3 compares the GSE market share in minority census tracts versus non-minority census tracts for separate census tract income intervals. This table show that while the GSE market share in non-minority census tracts ranges from 61.27% to 69.62% for census tract within various moderate and middle income intervals, it never rises above 42.61% for minority census tracts in comparable census tract income intervals. While such census tract-based analysis does not by itself establish disparate treatment or disparate impact in violation of the federal non-discrimination laws, it does indicate that there are major disparities between neighborhoods along racial lines in accessing the GSE-operated secondary mortgage market. This disparity needs to be addressed directly in implementing the GSE housing goals.

Table 4 provides GSE market share data by borrower income category. This table indicates that borrower income related disparities in GSE market shares are not as great as neighborhood related disparities. Further, the GSE market share disparity is only substantial for low income borrowers and not much of a factor for borrowers with incomes above 80% of MSA

median family income.

Table 5 provides GSE market share data by borrower racial category. This table shows that the GSE market share is dramatically lower for African-American borrowers and moderately lower for Hispanic borrowers.

The failure of the GSE housing goals to provide residents of many minority neighborhoods and low and moderate income neighborhoods and, more generally, minority borrowers and low and moderate income borowers with the same access to the secondary mortgage market enjoyed by most Americans is rooted in a number of major structural flaws in the 1992 GSE housing goal legislation.

First, the legislation used unduly broad definitions to determine the focus of the GSE housing goals with the result that they are not properly targeted on underserved sectors of the mortgage market. Much of this inadequate targeting or dilution is associated with misapplication of terms commonly used in CRA and community development activities. For purposes of the Low and Moderate Income Housing Goal, low and moderate income borrowers are defined to include not only borrowers with incomes less than 80% of MSA median family income (as they are for CRA purposes), but also borrowers with incomes between 80% and 100% of MSA median family income. Yet, Table 4 shows that in the Chicago PMSA, borrowers with incomes in the 80-100% of MSA MFI range (lower-middle income borrowers) have a GSE market share (69.03%) that is the same as the average GSE market share for the PMSA as a whole (68.92%). Why are GSE housing goals needed to encourage GSE purchases from this middle subsector of the mortgae market? Moreover, if the GSE housing goals were successful in encouraging the GSEs to change underwriting and other policies to stimulate more GSE purchases of loans to low and moderate income borrowers, would it not follow naturally that borrowers in the 80-100% of MSA MFI range would also benefit from such changes?

Similarly, for purposes of the Special Affordable Housing Goal, the GSE legislation defined low income borrowers to mean borrowers with incomes less than 80% of MSA median family income, rather than the 50% of MSA median family income standard used for CRA purposes. Yet, as Table 4 shows, it is borrowers with incomes below 50% of MSA MFI who have the most difficulty in accessing the GSE secondary market and clearly the most need for a "special affordable housing goal."

In addition, the GSE legislation established a geographic GSE housing goal that included all central cities, rural areas, and other underserved areas as defined by HUD. Clearly, this was an excessively broad definition of geographic areas with restricted access to the GSE-operated secondary market, although HUD has to some extent narrowed its scope by means of its regulatory authority to define underserved geographies

Second, the GSE legislation prohibits HUD from establishing enforceable subgoals for the Low and Moderate Income Housing Goal and the geographic area goal. Subgoals are a logical tool to ensure that the most underserved sectors of the mortgage market are given adequate consideration by the GSEs. For example, census tracts with minority population

percentages above 50%, or even 75%, would be good candidates for an enforceable subgoal.

Third, and perhaps most important of all, the GSE legislation failed to establish separate GSE housing goals (or sets of housing goals) for 1-4 family mortgage loans and multifamily mortgage loans. As result, in implementing all three statutory housing goals, HUD has devised a housing goal scoring system that counts the number of housing units financed by GSE loan purchases and combines 1-4 family units and multifamily units. This consolidation of 1-4 family and multifamily units has had a major impact in diluting the impact of the Special Affordable Housing Goal, the one statutory GSE housing goal that made some effort to achieve proper targeting.

Because a very high percentage of multifamily housing loans qualify for the Special Affordable Housing Goal, the GSEs can significantly reduce their obligation to purchase 1-4 family housing loans under the Special Affordable Housing Goal by increasing their purchases of multifamily mortgage loans. According to HUD, roughly 50% of the multifamily mortgage loan purchases of the GSEs qualify for the Special Affordable Housing Goal. In 1997, multifamily loans accounted for 44% of Fannie Mae's Special Affordable Housing Goal units and 31% of such units for Freddie Mac. In short, the commingling of 1-4 family housing loans and multifamily housing loans within the same Special Affordable Housing Goal basket enables the GSEs to trade-off performance on the 1-4 family side versus performance of the multifamily side.

Reinforcing these statutory weaknesses, HUD set the Special Affordable Housing Goal too low in the 1995 GSE rulemaking. Although HUD estimated that Special Affordable Housing units comprised 20%-23% of the market, it set the Special Affordable Housing Goal for the 1997-98 period at only 14% of GSE loan purchases measured on a housing unit basis.

Several basic reforms are needed to improve the working of the GSE housing goals. First, with respect to the 1-4 family side of the mortgage market, underserved sectors should be defined by looking at GSE market shares. Such market share analysis provides the most efficient means to identify underserved census tract categories, borrower income categories, and borrower racial categories. Obviously, such GSE market share data was not available to Congress in 1992 when it enacted the GSE housing goal legislation. Now that the data is available, Congress should examine it closely and restructure the statutory GSE housing goals to provide for better targeting.

In implementing the GSE housing goal legislation, HUD has generally relied on loan origination and loan denial rates derived from HMDA data to identify underserved segments of the mortgage market. While this approach has some value and we have employed it ourselves, our experience has been that GSE market share data provide a much sharper lens for identifying market segments that have restricted access to the GSE-operated secondary mortgage market. We recommend that HUD use this approach in its current rulemaking to bring as much targeting to the GSE housing goal rules as possible within the statutory framework.

Second, the GSE housing goal legislation needs to be restructured to provide separate

housing goals or sets of housing goal for 1-4 family housing and multifamily housing. This reform is needed to prevent the GSEs from trading off improved housing goal performance on the multifamily side for a reduced housing goal obligation on the 1-4 family side. As noted above, most of this trade-off takes place within the Special Affordable Housing Goal.

Multifamily housing loans and 1-4 family housing loans targeted toward underserved sectors are the most important elements of any strategy to address affordable housing needs. Thus, GSE housing goals should be structured in a manner that encourages the GSE to take affirmative measures on both fronts.

Third, better targeted GSE housing goals for 1-4 family housing loans are needed to encourage the GSEs to purchase more CRA-type mortgage loans originated by banks and savings associations. One of the main reasons why the GSE market share is so low in most minority and low and moderate income census tracts is that many of the mortgage loans originated in such tracts are CRA-type loans that often are not sold to the GSEs. In some cases, these loans have below-market rate features and the GSEs will not purchase such loans without discounting them to market rates. In our view, given the large indirect subsidies received by the GSEs and their substantial resources, including strong earnings streams, the GSE should share more equally with banks the various costs of effective CRA implementation. For example, in the case of CRA-type loans with below-market rates, the GSEs should absorb some of the cost of marking these loans to market. This would make banks more willing to sell CRA-type loans to the GSEs and this would, in turn, significantly expand the capacity of banks to originate CRA-type loans.

Fourth, HUD should establish a process for administrative review of GSE performance at the local level when the GSE market share data indicate that the GSEs have significantly underserved minority census tracts or low and moderate income census tracts within a particular MSA or rural area. Local government officials, community groups, and lenders should be encouraged to participate in this administrative review. The goal of this administrative process should be to encourage the GSEs to make commitments to improve their housing goal performance in the local community.

Review of GSE peformance within individual MSAs or rural areas is important because if the GSEs are evaluated only in terms of national targets they can substantially underserve individual MSAs and still meet these national targets. Also, it is very difficult to set uniform targeting standards that are appropriate for all MSA or rural areas in the nation. In particular, the relationship between minority percentage of census tract population and GSE market share varies dramatically in different parts of the nation. In Brooklyn, neighborhood access to the GSE-operated secondary mortgage market may not be greatly restricted until the minority percentage rises well above 50%. By contrast, in Iowa, such restricted access may be seen in census tracts with a minority percentage of only 15%.

Fifth, with respect to 1-4 family mortgage loans, separate and enforceable subgoals should be established for home purchase loans and refinancing loans. The GSE housing goals could be implemented much more effectively if for evaluation purposes the home purchase loan market

were separated from the volatile and increasingly controversial refinancing loan market.

Finally, some comment on whether the GSEs should be given housing goal credit for the purchase of subprime loans is appropriate. In many minority neighborhoods of the nation's larger cities, more than 40% or even 50% of the refinancing loans originated in 1998 were made by mortgage lenders that HUD has classified as subprime lenders. If the GSEs were to purchase a substantial share of these loans and were given housing goal credit for such purchases, this would be booked for evaluation purposes as a substantial improvement in GSE housing goal peformance in these neighborhoods. In our view, however, the primary mission of the GSEs with respect to housing goals should be to bring as many borrowers as possible into the mainstream of prime mortgage credit financing or provide a strong secondary market for legitimate CRA-type lending. At this point, it would be counterproductive to this underlying GSE mission to encourage the GSEs to purchase subprime loans by giving them housing goal credit for such purchases.

Prepared Testimony of
John E. Taylor

President and CEO
National Community Reinvestment
Coalition

Before the
Subcommittee on Capital Markets, Securities,
and Government Sponsored Enterprises

U.S. House of Representatives

June 15, 2000

These remarks represent the views of over 720 community reinvestment organizations that comprise the membership of NCRC.

Mr. Chairman, I wish to thank you for asking the National Community Reinvestment Coalition (NCRC) to testify this morning on the question of consolidating oversight of the Government Sponsored Enterprises (GSEs). NCRC is the nation's CRA trade association of more than 720 community organizations and local public agencies dedicated to increasing access to capital and credit for inner city neighborhoods and rural communities. As the President and CEO of NCRC, I have represented the coalition in many capacities including serving on the Consumer Advisory Committee of the Federal Reserve Board, the Advisory Board of the Community Development Financial Institutions Fund, and most recently as member of the HUD/Treasury Task Force on Predatory Lending.

Mr. Chairman, NCRC supports your efforts to consolidate oversight of the GSEs by replacing the three regulatory agencies with one. A report by the General Accounting Office correctly suggests that a single regulator of the GSEs will enhance the compliance of the GSEs with their mission of providing financing of affordable housing in a safe and sound manner. The GAO report entitled *Government-Sponsored Enterprises: Advantages and Disadvantages of Creating a Single Housing GSE Regulator* (July 1997) lists five criteria for effective regulation:

1) objectivity and arm's length status from the GSE
2) prominence in government
3) economy and efficiency
4) consistency in the regulation of similar markets
5) separation of primary and secondary market regulation[i]

A single regulator will be more efficient. One regulatory agency will find it much easier to coordinate regulation over safety and soundness and compliance with the mission of providing affordable housing finance. The single regulator will also be more efficient in the sense that it can more easily gauge the competitive impacts of proposed regulation on Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. The goal is to induce the three GSEs to be more competitive in the minority and lower-income part of the housing market. One agency will be in a better position to gauge whether regulation provides equal competitive impetus to the three GSEs or poses a handicap to a particular GSE.

A single regulatory agency will certainly be more prominent and influential. Mr. Chairman, the Office of Federal Housing Enterprise Oversight (OFHEO) has still not implemented a risk-based capital rule for Fannie Mae or Freddie Mac more than eight years after the passage of the Financial Safety and Soundness Act of 1992. Instead of independent authority to assess fees from Fannie Mae and Freddie Mac for its oversight, OFHEO must rely on annual approval from Congress. OFHEO's dependence on the annual appropriations process and its relative obscurity have hampered its effectiveness.

Like OFHEO, the Federal Housing Finance Board (FHFB) does not possess the characteristics recommended by the GAO for regulatory agencies. It is not an arms-length, independent regulatory agency. The FHFB is involved in the governance of the Federal Home Loan Banks. It appoints six of the Board Directors of each of the FHLB

banks. The GAO points out that regulatory agency involvement in the governance of the entities it regulates contributed to the savings and loans crisis. Fortunately, the FHLB Bank System is not anyway near that crisis point. NCRC, however, does not see a compelling reason to continue with a regulatory structure that has proven problematic in the past.

Mission Oversight

A prominent regulatory agency is needed for ensuring compliance with the GSE mission of providing affordable housing finance. A regulatory agency must be strong enough politically in order to enforce robust standards in affordable housing finance. The Department of Housing and Urban Development has done a commendable job developing and implementing affordable housing goals for Fannie Mae and Freddie Mac. The two GSEs have significantly increased their purchases of mortgages made to minority and low- and moderate-income populations. In report produced for HUD (see the appendix to our testimony for a copy of the report), however, NCRC found that Fannie Mae and Freddie Mac trail banks in the percentage of mortgages financed that were issued to minorities and low- and moderate-income populations. NCRC received constructive criticism from the GSEs regarding the data limitations of our study. While NCRC believes that our research was careful and that our conclusions were sound, we agree with the GSEs that the data on secondary market activity needs to be improved. Again, this is where a strong regulatory agency can ensure that complete and accurate data are gathered so as to measure GSE compliance with their missions.

The Federal Housing Finance Board is in the middle of a regulatory rule-making exercise that will make permanent, the pilot secondary market programs of the Federal Home Loan Banks. Under the pilot program, the FHLB Banks assume the interest rate risk of mortgages while the member bank and thrifts assume the credit rate risk of the mortgages. This could be an important mechanism for financing substantial number of mortgages made to minorities and low- and moderate-income borrowers. The FHFB discussed the importance of affordable housing goals, but then back away from implementing any of these goals in its proposed regulations.[ii] NCRC disagreed with this position, stating that it was imperative to implement affordable housing goals, similar to those for Fannie Mae and Freddie Mac, from the outset of a secondary market program of the FHLB system. NCRC suggested a number of feasible alternatives for affordable housing goals in order to ensure that the secondary market program finances a significant number of mortgages made to traditionally underserved populations.

A single regulatory agency, tapping into HUD's expertise with affordable housing goals, should implement such goals for any new secondary market program. This would ensure that all the GSEs continue to do their part in financing affordable mortgages.

Safety and Soundness as it Relates to Predatory Lending

A strong regulator enhances the safety and soundness of the financial institutions it regulates. A strong regulatory agency also takes bold steps to curb predatory lending practices that harm consumers and also threatens the safety and soundness of the GSEs.

Mr. Chairman, the leadership of Fannie Mae and Freddie Mac realize that they must not finance unsound predatory practices. Freddie Mac's CEO Leland Brendsel and Fannie Mae CEO Franklin Raines have announced that they will not purchase loans with prepaid credit insurance. Both of them have stated they will not finance loans featuring usurious interest rates and steep fees. Fannie Mae has gone a bit further in this regard by saying it will not finance mortgages in which fees are 5 percent or more of the loan amount. The two CEOs have also indicated that they will not purchase loans with stiff prepayment penalties or purchase loans from lending institutions that do not report credit payment histories to the credit bureaus.[iii]

These are important steps, Mr. Chairman. But it is also important to recognize that Mr. Brendsel and Mr. Raines will not have control of the reins at Freddie Mac and Fannie Mae forever. Also, other predatory mechanisms in addition to credit insurance and high fees strip wealth and lead to foreclosure.

In order to ensure comprehensive protection against predatory lending, the Federal Reserve should use its regulatory authority under HOEPA (Homeowners Equity Protection Act) to lower the interest rate and fee thresholds for high cost loans. The Federal Reserve should also limit and prohibit abusive terms and practices such as high balloon payments, steep prepayment penalties, and lending without regard of the borrowers ability to repay. Your bill, H.R. 3703, should empower a new regulatory agency over the GSEs to prohibit the purchase of predatory loans with abusive terms and conditions.

Unfortunately, Mr. Chairman, predatory lending is on the increase and it threatens the financial health of borrowers and financial institutions. The FDIC is in the midst of large bailouts of three banks, BestBank of Colorado First National Bank of Keystone in West Virginia, and Pacific Thrift and Loan Company of California, that made large amounts of subprime loans.[iv] Almost every day, the trade papers carry stories of financial problems experienced by subprime lenders. Aames is one such lender that has been in the papers lately.

The federal banking agencies recognize the clear links between unsafe and predatory lending practices. Julie Williams, the First Senior Deputy Comptroller and Chief Counsel of the Office of the Comptroller of the Currency, remarked recently that, "in our view, a mortgage loan for which there is no reasonable expectation of repayment without recourse to collateral is presumptively an unsafe and unsound loan, and making or purchasing such loans on a regular basis is inconsistent with safe and sound banking practices." She then states that the OCC is instructing its examiners to review loans for these features, to adversely classify these loans on safety and soundness exams, and to

prevent banks from accruing interest on these loans.[v] Like the bank regulatory agencies, the GSE regulator must start adopting tough regulations and examination practices for identifying and penalizing the financing of predatory lending.

While not all subprime lending is predatory, the segment of subprime lending that is predatory threatens the well being of our country and the progress that has been made in reinvesting in minority and working class communities. Part of a comprehensive solution to eliminating predatory lending is aggressive oversight and regulation of GSE involvement in the subprime market.

Data Disclosure

Expand HMDA and GSE Databases

Section 103 of H.R. 3703 requires the GSEs to publicly disclose on an annual basis financial, business, and other information that is in the public interest because the availability of such information would increase the efficiency of the secondary mortgage market of the housing finance system. NCRC commends the Chairman for including this provision in his bill. Publicly accessible data is the key to holding the GSEs accountable for efficient and equitable financing of mortgages.

NCRC also asks the Chairman to consider enhancements to HMDA (Home Mortgage Disclosure Act) data, the Public Use Database, and other databases on GSE activity that would provide more information on loan terms and conditions being offered to borrowers of different creditworthiness. Recently, in their request for public comment, the Federal Housing Finance Board asked if a database on Home Loan Bank secondary market activity should include the banks originating the mortgages, prepayment penalties, front-end and back-end ratios, FICO scores, loan-to-value ratios (LTV), percent of private mortgage insurance, income level of the borrowers, if the borrower was a first-time homebuyer, and other characteristics of the mortgages and borrowers. NCRC strongly supported the inclusion of this information in the FHFB database and urged that this data should be public. NCRC supports this type of information being publicly available in HMDA and the public use database as well. All of the databases should also have information on the Annual Percentage Rate (APR).

Information on borrower creditworthiness and loan terms and conditions will enable the general public and the regulatory agencies to determine if lending practices are safe and sound and if they comply with anti-discrimination law and regulation. Indeed, this type of data disclosure would meet the intent of Section 103 in that it would be in the public interest and would increase the efficiency of the secondary mortgage market.

Transparency of Credit Scores

Consumers, regulatory agencies, and financial institutions have a right and a responsibility to understand how credit-scoring systems judge the ability of consumers to pay loans. Greater transparency of credit-scoring systems would enhance the safety and soundness of the financial industry by allowing all parties to judge, question, and debate

the soundness of the credit-scoring criteria. Greater transparency also enhances industry compliance with the fair lending laws and helps additional minority and low- and moderate-income borrowers prepare themselves for homeownership.

It is worth quoting from a speech that Fannie Mae CEO Franklin Raines delivered at NCRC's annual conference this past March. He states:

> Consumers have a right to understand what is behind a lender's decision. They have a right to know how they are being judged, on what basis. While automated underwriting has taken the bias out of loan decisions, consumers are still too much in the dark about how these systems work. I believe consumers have a right to know what's in the system. So last January, Fannie Mae revealed the 14 decision factors used by our underwriting system, Desktop Underwriter. But we're going to go farther than that. Our next step is to stop relying on the FICO credit score, which is too opaque. We're going to develop our own credit-assessment model. We won't have a black box or even a glass box. We will have a completely open book.

Fair Isaac just last week followed Fannie Mae's lead by posting the factors in FICO scores on its web page. NCRC encourages Freddie Mac do to likewise.

In addition to more transparency in credit scores, NCRC asks Fannie Mae and Freddie Mac to agree to let lending institutions use reputable credit scoring systems that are effective in qualifying high numbers of minorities and lower income borrowers and that also have good track records in predicting default. The GSEs should agree to allow these lenders to use their models without also having to use Desktop Underwriting or Loan Prospector. NCRC would also encourage the GSEs to ask their regulatory oversight agency to review lenders' credit scoring systems if they want a second opinion regarding safety and soundness and fair lending compliance.

The regulatory oversight agency should encourage a wide diversity of credit scoring systems, competing against each other in developing sound and flexible underwriting criteria. This will open more doors to homeownership for minorities and low- and moderate-income borrowers. In addition, the regulatory oversight agency should continue conducting fair lending testing of the GSE underwriting systems as HUD has just started doing.

Finally, and importantly, NCRC believes that the borrower has the right to know his or her specific credit score and the factors that went into the credit score. Fair Isaac has just announced that it will start providing borrowers their credit scores in the near future.[vi] Likewise, the GSEs should disclose the credit scores and the factors behind the scores for any credit scoring system that they develop. H.R. 3703 should require disclosure of any GSE credit scores.

Structural & Jurisdictional Issues

HUD as the Regulatory Agency

As stated above, NCRC agrees with the GAO that a single regulatory agency would be most efficient. NCRC is not convinced, however, that the regulatory agency needs to be newly-created with a board representing many different interests. Fannie Mae and Freddie Mac have a legitimate point about the unwieldy nature of a board.

HUD is a logical choice because it carries the prominence of a cabinet level department and has been the regulator for both safety and soundness and mission compliance for Fannie Mae and Freddie Mac. Perhaps, the new oversight agency within HUD can be on a semi-independent basis like OFHEO is now. To bolster its position of independence and prominence, the new agency should be funded by assessments on the GSEs instead of through the appropriations process. H.R. 3703 wisely adopts the assessments as the funding mechanism.

Prior Approval Authority

H.R. 3703 has generated some controversy regarding Section 110 which grants the new regulatory oversight agency the authority to approve new activities undertaken by the GSEs and implements a public notice and comment period. NCRC agrees that prior approval authority and a public comment period process is appropriate and necessary for a regulatory agency with responsibilities over mission compliance and safety and soundness. Currently, HUD has new program and approval authority over Fannie Mae and Freddie Mac.

In addition to HUD's authority over the GSEs, banking law establishes precedents for prior approval activity and public comment periods. Before the Gramm-Leach-Bliley Act of 1999, the Office of the Comptroller of the Currency established a prior approval procedure for activities in operating subsidiaries of nationally-chartered banks. In Part 5 of 12 CFR (Code of Federal Regulations), the OCC requires operating subsidiaries to file an application for new activities that are part of or incidental to the business of banking. Further, in Section 5.34, the OCC gave itself the authority to hold a public comment period for those activities that present "significant and novel policy, supervisory, or legal issues…"

More recently, Section 103 of Title I of the Gramm-Leach-Bliley Act requires consultation between the Department of Treasury and the Federal Reserve Board before either agency approves new activities that are financial in nature. When the Department of Treasury determines that an activity is financial in nature, the Federal Reserve Board has the authority to initiate a public rulemaking process with a public comment period.

Ample precedent exists for public comment periods for new financial activities precisely because they have profound safety and soundness and fair lending implications. Fannie Mae and Freddie Mac purchase about half of the mortgage loans made in the country

according to the Department of Housing and Urban Development. Adding the secondary market involvement of the Federal Home Loan Banks is likely to push the GSEs into managing, holding in portfolio, and securitizing more than half of the mortgages made in the country. Since the GSEs are likely to be involved in the majority of secondary market mortgage transactions, NCRC believes it is in the public interest to establish an approval process and hold a public comment period to determine if new GSE activities are consistent with safety and soundness and their affordable housing mission.

While NCRC prefers a mandatory public comment period for new activities, the approach of a discretionary public comment period has been and is now being utilized by financial regulatory agencies. NCRC does not think that the GSEs should seek approval for new versions of existing products like Freddie Mac's *Affordable Gold* or Fannie Mae's *HomeStyle*. What is of most concern to us is that the GSEs do not adopt new products that exceed the authority in their charter such as loan and insurance products. The regulatory agency should have prior approval authority in cases in which they think products go beyond GSE charters. The regulatory agency should also have the authority to review new products after they have been on the market and to review modifications to existing products to ensure that these products do not exceed GSE charters.

In the event that Fannie Mae, Freddie Mac, and the Home Loan Banks do not meet affordable housing goals, the oversight body should be in the position to prohibit new products that do not have the capacity to serve substantial numbers of minority and low- and moderate-income consumers.

Line of Credit with the Department of Treasury

NCRC believes that the GSEs should continue to have access to lines of credit with the Department of Treasury if the GSEs meet their affordable housing goals. Implicit government guarantees for the GSEs have resulted in lower mortgage costs for consumers. If the GSEs, however, are not meeting their statutory responsibilities under the affordable housing goals, they should not have access to lines of credit from the federal government. NCRC proposes that the line of credit be cut-off if a GSE does not meet affordable housing goals for two consecutive years.

In Conclusion

NCRC thanks the chairman for the opportunity to testify today. Our 720 member organizations believe that strong regulation is the path to a profitable financial industry that serves all customers in a non-discriminatory manner. We recommend the following:

- HUD become the single regulatory agency over the GSEs.

- HUD has the explicit authority to regulate GSE involvement with subprime lending and prohibit the financing of predatory lending.

- GSE and lender data disclosure should be expanded to include the annual percentage rate and loan term and conditions.

- HUD continue fair lending oversight of GSE underwriting and credit scoring systems. HUD ensure that consumers have the right to any credit scores the GSEs develop as well as an explanation of the factors behind the scores.

- The regulatory agency has the authority to assess the GSEs for regulatory oversight, and does not have to have this authority approved annually by Congress.

- The single regulator has the authority to approve new activities and hold public comment periods.

- The GSEs continue to have access to Treasury Department lines of credit, but not if they fail to meet the affordable housing goals for two consecutive years.

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[i] General Accounting Office, *Government-Sponsored Enterprises: Advantages and Disadvantages of Creating a Single Housing GSE Regulator*, GAO/GGD-97-139, p.6.
[ii] Federal Housing Finance Board, Proposed rule on Federal Home Loan Bank Acquired Member Assets, Core Mission Activities, Investments and Advances, in the *Federal Register*, May 3, 2000, pages 25676-25692.
[iii] Fannie Mae News Release, Fannie Mae Chairman Announces New Loan Guidelines to Combat Predatory Lending Practices, April 11, 2000, available from http://www.fanniemae.com/news/pressreleases. David A. Andrukonis, Chief Credit Officer, Freddie Mac, letter to the editor in the *American Banker*, April 6, 2000.
[iv] Oral Statement of Donna Tanoue, Chairman of the Federal Deposit Insurance Corporation before the Committee on Banking and Financial Services, U.S. House of Representatives, February 8, 2000.
[v] Remarks by Julie Williams, First Senior Deputy Comptroller of he Currency, before the Robert Morris Associates/Consumers Bankers Association, 5[th] Annual Consumer Risk Management Conference, Chicago, Illinois, June 5, 2000.
[vi] American Banker, *Fair, Isaac to Tell People their Credit Scores*, Friday, June 9, 2000. Also see http://www.fairisaac.com.

Comments of Peter Skillern, Executive Director of the Community Reinvestment Association of North Carolina for the House of Representatives Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises Hearing June 15, 2000.

Greetings. My name is Peter Skillern. I am Executive Director of the Community Reinvestment Association of North Carolina (CRA-NC). Thank you for the opportunity to speak on the role of the Government Sponsored Enterprises (GSEs) and the fulfillment of their mission in serving low income and minority communities. CRA-NC is a nonprofit, community advocacy agency whose mission is to promote and protect community wealth through changes in financial institutions. CRA-NC has secured over $3.5 billion in community reinvestment commitments to promote wealth in the last 10 years. We have been in the leadership of North Carolina's anti-predatory lending movement to protect household wealth.

Through homeownership, America is a wealth building machine. Through homeownership, equity is created to start a business and or send children to college or provide for retirement. CRA-NC has a vision of a lending environment that is free of discrimination and credit is used to create wealth through homeownership for all.

Unfortunately, a segment of our population continues to be left behind in mortgage lending. Many are being taken advantage of through unscrupulous predatory lending practices in the subprime market. Tremendous credit can be given to the secondary market for creating the highest level of homeownership in the world. But today, I will speak to the role the GSEs play in those who are left out in the engine of wealth creation and those who are losing the wealth they have built.

These hearings play an important role in highlighting the GSEs federal charter as a privilege that must be continually earned. The tremendous financial benefits and the mission charge given the federal government places a significant responsibility on them to fulfill their mission statement.

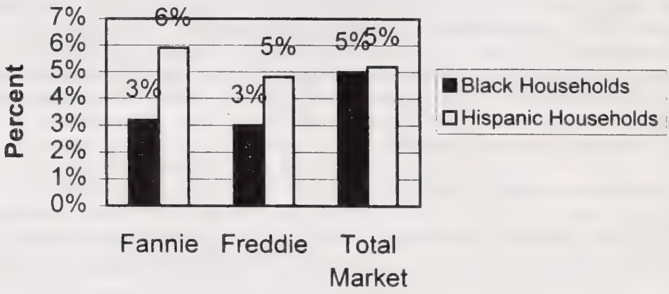
Because the GSEs wealth stems from the benefits of a democratic government, the institutions must be responsive and sensitive to the community from which both its political and economic benefits are founded.

My comments focus primarily on our concerns that where the GSEs are not active in the prime mortgage market, there is an increase in subprime lending. As the two GSEs move into the subprime market, we have strong reservations that without adequate consumer protection policies in place, the GSEs may do more harm than good.

Lending to Minorities Needs to Improve

During the review of the HUD Affordable Housing Goals, both Fannie Mae and Freddie Mac have received criticism that they do not adequately purchase loans from minority households and neighborhoods.

Percent Loans Made or Purchased to Black and Hispanic Housholds in 1998



Source: Washington Post "HUD Says Mortgage Policies Hurt Blacks" March 2, 2000 Data are from the US Department of Housing and Urban Development

> *But in the Triangle, Fannie and Freddie have been buying most of their loans in neighborhoods where folks are white and earn above-average incomes...*
> *Cary and other mostly white communities with family incomes greater than the Triangle median of $40,000 saw 40 times as many Fannie and Freddie loan purchases as did all minority neighborhoods combined from 1994 to 1998, the five years of data...*
> *Even in minority neighborhoods with greater-than-average family incomes, Fannie and Freddie rarely bought loans: 63 in 1998, compared with 2,297 purchased the same year in white neighborhoods with below-average incomes."*
> *March 19, 2000 News and Observer article: "Freddie, Fannie Failing Many"*

We recognize that the GSEs have disputed these claims and that there are many good initiatives that deserve recognition. We also appreciate their acceptance of the fact that more could be done to improve minority lending.

Yet, banks can not make loans without a secondary market to sell them to. The costs and risks become too high. Without proactive policies in place to purchase loans from under-served areas and populations, the GSEs will continue to be under-represented in these communities. Where the GSEs don't buy loans, banks won't originate them.

Credit Gap in Minority Communities Feeds Subprime Lenders

The absence of bank loans creates a credit

gap that subprime lenders fill.

Subprime lending is higher cost credit through fees and interest rates. The lack of prime lending in minority communities correlates with the level of subprime loans. Subprime lending disproportionately impacts minority communities.

According to HUD's April 2000 report "Unequal Burden: Income and Racial Disparities in Subprime Lending in America," subprime loans are five times more concentrated in Black neighborhoods than in white neighborhoods. Homeowners in high-income Black neighborhoods are twice as likely to have subprime loans as homeowners in low-income white neighborhoods.

Subprime Lending

Subprime lending has the potential to be a credit-building tool for people to work towards improved credit. It has the potential to expand and democratize capital. If done correctly, the GSEs can play a positive role in expanding credit options in a fair and equitable way to people with impaired credit.

Pricing Problems

Theoretically, subprime loans are for higher risk borrowers who are not able to get a loan from a prime lender. In reality, the subprime market often captures A-credit borrowers as well. According to a report by Freddie Mac, "10 percent to 35 percent of borrowers who obtained mortgages in the subprime market were actually eligible for conventional loans."[1] According to Fannie Mae, half of all subprime borrowers could have qualified for lower cost conventional loans.[2]

Different and Unfavorable Terms and Conditions

In addition to pricing problems, the terms and conditions of subprime lending are often starkly different than that of the prime market. While some subprime lending is predatory through outright deception and fraud, the majority of subprime lending is harmful through unethical, if not illegal, practices such as high fees, steering to higher interest rates for yield spread premiums, balloon payments, and prepayment penalties. These loan practices drain wealth rather than build wealth.[3]

Unregulated

The subprime market is not regulated as the prime market. Depository institutions are regulated for consumer compliance and safety and soundness by the Federal Deposit Insurance Corporation, the Federal Reserve, the Office of Thrift Supervision, the Office of the Comptroller.

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[1] Peter Mahoney and Peter Zorn, "The Promise of Automated Underwriting" Secondary Mortgage Markets, November, 1996.

[2] See Fannie Mae press release at page four: http://www.fanniemae.com/news/pressreleases/0667.html and "Half of Subprime Loans Categorized as 'A' Quality," Inside B&C Lending, June 10, 1996.

[3] Please see CRA-NC's Introduction to Predatory Lending Policy book for a more thorough discussion of how subprime and predatory lending works. It can be found online at http://www.cra-nc.org/predpolicy.pdf)

Mortgage brokers, non-depository mortgage lenders and warehouse lenders are regulated only on a complaint driven basis by the US Department of Housing and Urban Development or the Federal Trade Commission. They are not evaluated on a regular basis for compliance.

GSE Entry into Subprime Market

Both Fannie Mae and Freddie Mac have stated their intent to enter the subprime market. To date only Freddie Mac has significantly done so. According to *Inside B and C Lending*, Freddie Mac has wrapped $8 billion of securities of subprime loans through 1999. Freddie Mac has announced plans to increase purchases up to $30 billion a year.

Freddie Mac has a partnership with Option One wrapping five asset backed securities totaling over $3 billion dollars. Option One benefits from its partnership with Freddie Mac. According to its Chief Financial Officer the partnership expands the market for the securities and adds 15 to 20 basis points in profit. On a billion dollar transaction, this is an additional $1.5 million to $2 million in earnings.[4]

Case Study of an Option One Loan

We question whether this type of subprime lending also serves the community given the stated concerns with subprime lending. The following is a true story of a client that is illustrative of how this market works:

Mary and Tom Smith[5] obtained a subprime loan from a mortgage lender. The Smiths are retired, on a fixed income, and own their home. They borrowed recently to help send one child through college and to help another child as she recovered from cancer. Their payment history is good. The Smiths are African American.

Armada Mortgage of Raleigh told the Smiths that they could reduce their monthly payments by consolidating their debt and refinancing their mortgage. The interest rate they were told would be 8%. At closing they found that the interest rate was actually 9.75% -10.75% APR. The monthly payments would not be under $1,450 as promised, but over $1,700 a month. The Smiths were charged $7,400 to originate a loan of $172,000. Their existing mortgage of $120,000 was included in the refinance though it its rate was lower than 8%.

At closing, the Smiths discovered that there was a balloon payment of $150,000 on a total debt of $182,000 on the 180th payment (15 year term). In response to their concerns, the Smiths were promised that they could refinance the loan to a lower interest rate in two months. Being too polite to walk out of the deal they signed the loan documents. In two months' time, the Smiths went to the lender to get the promised lower interest rate, but were told they could not. They approached another lender to refinance, but were told they had a prepayment penalty of six months' interest if they refinanced within 36 months. Six months' interest is equal to over $8,500.

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[4] Inside B and C Lending November 29, 1999

[5] To protect the privacy of these borrowers, their names have been changed.

This loan demonstrates our concerns about the GSEs entering the subprime market. The Smiths have a good credit history, but were charged a high interest rate and abusive fees on their subprime loan. It is industry practice to pay a yield spread premium to place a subprime borrower in higher interest rate loans than they deserve. CRA-NC is concerned that the Smiths may have been steered into a higher interest rate loan than what they qualified for.

The terms and conditions of the Smith's loan are harmful. While the balloon payment artificially lowers the monthly payment, the principle will not be repaid. The prepayment penalty either assures that the Smiths do not refinance for a better loan or that they pay a premium for doing so. The high origination fee of $7,400 was not justified by the work it took to originate this loan. The effect of the Smiths loan is to strip wealth, not build it, through high fees, a high interest rate and a high prepayment penalty.

This loans, and others made by Option One, are made in an unregulated environment. HUD or the FTC evaluate both the originator and the wholesale lender only if a significant number of complaints are filed. Both lenders involved in this case are exempt from registering with the North Carolina Banking Commission.

Armada Mortgage, the loan originator, or "table lender" sold the Smith's loan to Option One. As described before, Option One partners with Freddie Mac to sell securities. Freddie Mac provides liquidity to Option One, allowing it to make and purchase more such abusive loans.

Fair Housing Compliance Questioned

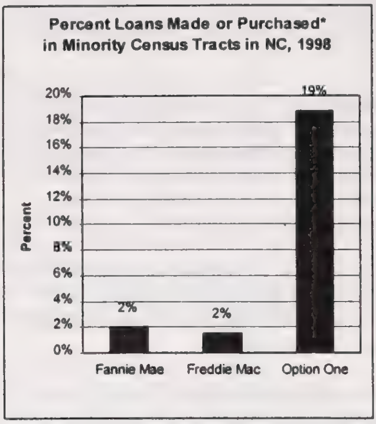
The GSEs are prohibited by the Fair Housing Act from discrimination in making or purchasing mortgages in pricing, access, terms or conditions.

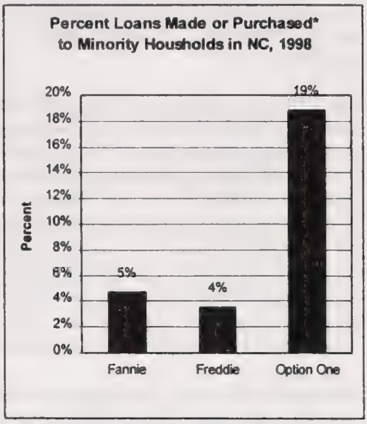
Sec. 805 (42 U.S.C. 3605) of the Fair Housing Act reads:

"It shall be unlawful for any person or other entity whose business includes engaging in residential real estate – related transactions to discriminate against any person in making available such a transaction, or in the ***terms or conditions*** *of such a transaction, because of race, color, religion, sex, handicap, familial status or national origin. (b) Definition.—As used in this section, the term "residential real estate-related transaction" means any of the following: (1) The making or* ***purchasing*** *of loans or providing other financial assistance. (A) for purchasing, constructing, improving, repairing, or maintaining a dwelling; or (B) secured by residential real estate."*

In North Carolina, HMDA data show that Freddie Mac lends more of its prime portfolio to whites than blacks when compared to the market. At the same time it is providing assistance in the purchase of loans that have a high level of pricing problems, harmful terms and conditions. These loans are five times more likely to be located in black neighborhoods than white neighborhoods. These policies result in a disparate impact in the terms, conditions, pricing and access between white and African American

communities. Funding subprime lending fuels the separate and unequal credit markets that currently exist.





*(*Fannie Mae and Freddie Mac purchases of prime, single-family home purchase or refinance loans, Option One originations of single-family mortgages in North Carolina in 1998.)*

Safety and Soundness Concerns

The Smiths will be strained to make their mortgage payments. If they, or others like them, default on their loans, it will mean losses for the GSEs. High default rates may not affect the safety and soundness of the GSEs at their current level of involvement in the subprime market, but as they become more involved, it may become a problem.

However, our neighborhoods definitely can not afford high default rate stemming from these loans. Let me be on the record predicting that foreclosure rates in minority neighborhoods from these high cost loans will become a significant problem in the coming years. In the future, this committee will return to the issue of how the financial markets played a role in spurring high default rates and the decline of our neighborhoods.

Solutions

Corporate Responsibility
What are the remedies? One is to for the GSEs to adopt self guiding principles in purchasing subprime loans as recommended by consumer groups. These recommendations are attached. Fannie Mae has agreed to all of these policies – except the application of prepayment penalties to wraps. Another recommendation is to commit more financial and human resources to the task of community lending. A list of recommended actions for North Carolina is attached. Again Fannie Mae has made a

concerted effort to make a difference in North Carolina it is appreciated. Freddie Mac is beginning to invest more with the establishment of a new community development lending office in North Carolina, and we look forward to more.

Regulatory Reform

CRA-NC believes that HUD has the authority to define the entry into subprime lending as a new program and to exercise its oversight to draw the boundaries of what should and should not be allowed.

Specifically, the GSEs should not be allowed to receive credit for affordable housing goals that are not monitored for compliance with fair housing laws, that have prepayment penalties, origination fees over 3%, or single-premium credit life insurance.

HUD does need to be given congressional authority to have an onsite presence at the GSEs to monitor for fair housing and program compliance. Just as other financial institutions pay fees for the benefit of being federally regulated - so too should the GSEs support adequate staffing to monitor for compliance purposes.

OFHEO needs congressional authority to look for consumer compliance issues as a safety and soundness issue. Historically Freddie purchased loans only from regulated institutions. This is no longer true and oversight is needed.

A new regulatory framework as you have recommended may indeed be needed if changes to the existing system are inadequate. But even a new regulatory body may not exercise its legal or moral authority to change the institution's practices. That is up to us today.

Thank you very much.

Principles for Responsible Lending

Predatory lending is any unfair credit practice that harms the borrower or supports a credit system that promotes inequality and poverty. Financial institutions are called upon to follow these Principles for Responsible Lending to end predatory practices and to provide credit in a fair manner, free of discrimination and harm.

1. **Targeting and outreach:** Loans marketed to minorities, elderly, or low-wealth borrowers will have fees and rates no higher than loans aimed at the general public.
2. **Loan fees:** Consumer loans will not have total upfront charges greater than 3% of the loan amount.
3. **Rates:** Interest rates are set by a nondiscriminatory, consistent, and rational method in which price relates to actual loan risk.
4. **Prepayment:** No prepayment penalty will be offered on subprime loans.
5. **Steering:** Lenders will not provide employee or third party incentives to steer minority, elderly, or low-wealth borrowers to loans that have higher fees or interest rates than the borrower's credit history would warrant.
6. **Credit insurance and loan packing:** Credit insurance and other loan extras will not, directly or indirectly, be financed into the loan amount.
7. **Flipping:** A loan will not be refinanced where the total cost of the loan is disproportionate to the total benefit to the borrower.
8. **Yield spread premiums:** Firms will neither pay nor receive indirect compensation from lenders to a loan broker/lender that rewards a broker or lender for placing a borrower in a loan with higher fees or interest rates than required by the borrower's creditworthiness.
9. **Financing predatory lenders:** Financial institutions will not make direct or indirect investments or loans to firms with a documented history of predatory lending practices.
10. **Credit reporting:** Lenders will report accurately to credit bureaus the payment records of low-wealth borrowers so that favorable refinancing is a viable option for the borrower.
11. **Payoffs and servicing history:** There will be no delays in posting payments or providing payoff quotes, or other practices that increase a borrower's loan payoff balance or hinder the borrower's ability to refinance to a more favorable loan.
12. **Collections:** Collection calls and notices will be respectful and reasonable.
13. **Education:** Reasonable efforts will be made to insure that customers understand the terms of the loans they receive. Lenders will financially support community based financial counseling.
14. **Reinvestment:** Lenders will demonstrate a commitment to serve and reinvest in all of the financial institution's customer communities.

Community Lending Initiatives

The Community Reinvestment Association of North Carolina proposes these actions steps and goals for GSEs to increase loan purchases in minority, rural and low-income areas on a flow basis in North Carolina.

* Increase purchase of bank CRA portfolios to at least $200 million a year.

* Increase clean subprime product program in North Carolina. These programs should be expanded to other lenders and tied in with the redevelopment efforts of Eastern North Carolina.

* Develop partnerships with small rural banks to provide greater liquidity. We recommend adding new small banks to your client pool and increasing loan purchases for rural areas.

* Establish a relationship with Mechanics and Farmers Bank and Mutual and Savings Bank, Millennium Bank (minority owned banks).

We propose these actions to increase GSEs investments and contributions in the community development sector of North Carolina.

* Provide financial support for housing and credit counseling programs through our statewide collaborative initiative.

* Develop partnerships with state and local nonprofits to finance development of low-income housing and redevelopment efforts.

* Invest in Low Income Housing Tax Credits through North Carolina institutions.

* Purchase of Mortgage Revenue Bonds from the North Carolina Housing Finance Agency.

* Invest in the Community Investment Corporation of North Carolina pool of multi-unit financing.

WILLIAM MICHAEL CUNNINGHAM
Registered Investment Advisor

TESTIMONY BY WILLIAM MICHAEL CUNNINGHAM Before the HOUSE BANKING SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES AND GOVERNMENT SPONSORED ENTERPRISES

Thank you, Mr. Chairman, Representative Kanjorski, Members of the Subcommittee, for giving me the opportunity to testify on the supervision and regulation of government sponsored enterprises, or GSE's. Your bill, H.R. 3703, the *Housing Finance Regulatory Improvement Act*, comes at a critical time. The bill proposes a new regulatory structure for three government-sponsored enterprises (GSE's). Given the importance of this legislation, I am honored to have an opportunity to comment. It is appropriate to note, however, that my comments represent my own views and are not meant to represent the views of my employer, the Board of Pensions of the Evangelical Lutheran Church in America. Nor do my views represent opinions from the GSE's themselves or Wall Street. I come before this Committee as an independent investment analyst.[1]

I will divide my remarks into five parts: first, a general discussion on social investing; second, a description of the GSEs' role in social investing; third, background information on my activities in both social investing and the secondary mortgage markets. Fourth, I will outline my concerns with GSE performance in fulfilling their public purpose mission. I'll end with my view on certain aspects of the Baker bill

Social Investing

"Social investing" describes a style of investing combining a desire to maximize financial return with an attempt to maximize social "good." Many believe social investing began with the Religious Society of Friends, better known as the Quakers. In 1758, the Quaker Philadelphia Yearly Meeting prohibited members from participating in the business of buying or selling humans. Religious institutions have been at the forefront of social investing ever since. (In the interest of full disclosure, I feel it appropriate to note that I am a Quaker.)

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[1] I hold MA and MBA degrees from the Department of Economics and the Graduate School of Business at the University of Chicago, and earned my BA degree from Howard University in Washington, D.C. I am registered with the U.S. Securities and Exchange Commission as an investment advisor. From 1987 to 1988 I was a Security Sales Representative with Freddie Mac.

In general, social investors favor:

- *Environmentally responsible corporate practices*[2].
- *Corporate practices that support workforce diversity.*[3].
- *Corporate practices that result in increased product safety and quality*[4].

Social investing preferences are broad, however. Certain social investors prefer not to invest in companies involved in the production of medical equipment used in performing abortions, for example.

According to a study released by the Social Investment Forum (SIF), a nonprofit professional association dedicated to promoting socially responsible investing, more than $2 trillion is now invested in a socially responsible manner in the U.S. Social investments now account for about 13 percent of the estimated $16.3 trillion under professional management in the U.S.

Social Investing Strategies

Social investors use three basic strategies, outlined below.

SCREENING excludes certain securities from portfolios based on social criteria. For example, many socially responsible investors screen out tobacco company investments. Recently, "CalSTRS (California State Teachers' Retirement System) announced the removal of more than $237 million in tobacco holdings from its investment, portfolio after 6 months of financial analysis and deliberations." This is an example of a social screen at work.

SHAREHOLDER ACTIVISM. Shareholder activism efforts attempt to positively influence corporate behavior. These efforts include initiating conversations with corporate management, or dialoging, on issues of concern, and submitting and voting proxy resolutions. These activities are undertaken with the belief that social investors, working cooperatively, can steer management on a course that will improve financial performance over time and enhance the well being of the stockholders, customers, employees, vendors, and communities.

POSITIVE INVESTING involves making investments in activities and companies believed to have high and positive social impact. Positive investing activities tend to target underserved communities. These efforts support activities designed to provide mortgage and small business credit to minority and low-income communities. It is in this area that Fannie and Freddie are most active. According to their web sites:

"Freddie Mac is a stockholder-owned corporation chartered by Congress to increase the supply of money that mortgage lenders, such as commercial banks, mortgage bankers, savings institutions and credit unions, can make available to homebuyers and multifamily investors."

and

"Fannie Mae is a private, shareholder-owned company that works to make sure mortgage money is available for people in communities all across America. We do not lend money directly to home buyers. Instead, we work with lenders to make sure they don't run out of mortgage funds, so more people can achieve the dream of homeownership. "Fannie Mae is "the country's third largest corporation, in terms of assets, and the nation's largest provider of funds for home mortgages."

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[2] These practices give rise to "increased potential for cost savings in energy, water, land, and raw materials; reduced clean-up costs; decreased chance for legal liabilities; improved public image and community relations."

[3] These practices give rise to "enhanced global competitive edge resulting from a greater range of skills and perspectives; greater ability to attract and retain talented employees from a broad-based labor pool; reduced likelihood of EEO lawsuits and negative publicity."

[4] These practices give rise to "decreased chance for product liability lawsuits (e.g., tobacco); greater satisfaction and loyalty."

Clearly, these are positive investing activities. Carried out consistently, these activities have high and positive social impact. [5]

Background: Socially responsible investing and the secondary mortgage markets

Let me now speak about my efforts in both socially responsible investing and the secondary mortgage markets.

In a 1996 article in the Washington Post, I commented that:

> "It seems their (Freddie and Fannie's) primary mission has been completed and completed successfully. Now its time to look for a different mission, which could include finding mortgage money for low income parts of the District and housing the homeless."

Others have echoed this sentiment. Federal Reserve Board Chairman Alan Greenspan noted, in a letter to the Chairman of this Committee dated 5/19/2000,

> "(The GSE's) were each chartered with the purpose of smoothing out regional imbalances in mortgage supply and integrating regional mortgage markets into the national capital markets. Much to their credit, they succeeded in accomplishing this goal many years ago."

Mr. Chairman, I believe it is time to renew, refocus and broaden the mission of the GSE's. I believe the first step in doing so requires the adoption of a new regulatory framework, as outlined in your bill.

With respect to their mission, I would like to see the GSE's become much more active in the low end of the housing market ($127,000 versus the current Fannie/Freddie maximum loan limit of $227,150). Needs in this area are great. According to HUD,

- The housing affordability crisis facing very-low-income renters continues to worsen as 5.4 million renter households, a record high, are experiencing worst case needs for housing assistance.
- The number of working families with worst case housing needs has increased sharply since 1991.
- The stock of rental units that are affordable to extremely low-income renters has continued to shrink, with even sharper decreases in units that are both affordable *and available* to these renters.
- Worst case needs have become more concentrated among families with extremely low incomes.
- Worst case needs have increased most quickly in minority households, particularly among working families with children.
- Very-low-income families remain most likely to face worst case problems when they live in the suburbs.

In looking for a new, broader public mission, I suggest the GSE's also focus on housing markets populated by minorities and women. Devoting even a small percentage of GSE mortgage financing activity to markets populated by persons of low to moderate income, minorities and women will help even the distribution of income and wealth, contribute to domestic political and economic stability, and earn a competitive return. It is my belief that investors, women, and minorities are all well served by these efforts. Further, I believe it is possible to create targeted mortgage investments and portfolios that perform well financially and that address social concerns. I have uncovered many investment opportunities of this type. Let me describe one such investment opportunity.

Prior to joining the Board of Pensions of the ELCA in 1999, I served as CEO of Creative Investment Research, an independent investment research and management firm I founded in 1989. The firm specialized in socially responsible investing. My background in finance and investing led me to develop several socially responsible community investment products. One of these was a set of mortgage-backed securities originated by financial institutions owned by minorities and women and serving areas of high social need. As noted in the American Banker

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[5] "CBO Faults Subsidies for 2 Finance Firms," The Washington Post, Thursday, May 30, 1996. Page D-9.

Newspaper[6], I was the first investment advisor to create a mortgage-backed security (MBS) composed entirely of loans from minority and women owned financial institutions. Working with G.E. Capital[7], I identified minority owned lenders willing to participate in the program, arranged G.E. Capital's participation as aggregator of the loans originated by these minority owned financial institutions, and worked to place these MBS pools with a socially responsible institutional pension fund.

Social Investing Concerns: GSE's

Given their public purpose and mission, social investors have long believed Fannie and Freddie to be both positive investors and good corporate citizens.[8] In the main and for the most part, they are. But, I have been troubled by certain aspects of GSE corporate behavior over the years. I am deeply concerned with a recently issued report on GSE home mortgage lending to minorities. The report, issued by the U.S. Department of Housing and Urban Development, showed that, in 1998, "the share of GSE mortgages going to minorities trailed the national average of 15.3 percent. Fannie Mae lent only 14 percent and Freddie Mac lent only 12.2 percent to minorities.

The disparity is even more pronounced in mortgages to black Americans. While the total market for mortgages to blacks is 5 percent, Fannie Mae only lent 3.2 percent and Freddie Mac lent only 3.0."

I believe I can explain this data. A history of discrimination has created a lack of data on black borrowers, making it hard to predict which factors affect their repayment performance. Cultural and community differences may also affect loan performance. It is unlikely that the GSE's have an ethnically neutral set of evaluation criteria. Lacking a set of ethnically neutral loan evaluation tools, both Fannie and Freddie lent relatively fewer dollars to African Americans than others did. In essense, the GSE's may have incorrectly assessed home mortgage loan risk in minority markets. By reducing the flow of mortgages to minorities, GSE's may have ignored profitable lending opportunities. This behavior reduces GSE income and stifles the flow of mortgage credit. This, I think we all agree, is contrary to their Congressionally mandated mission.

We have seen other financial institutions repeat this behavior. On October 22, 1998, Freddie Mac Board member and economist Henry Kaufman, speaking of the Russian financial crisis, noted in the Washington Post that:

"All the problems pervading Wall Street just can't be blamed on outside forces..Institutions have incorrectly assessed risk. If they had done their due diligence, a lot of this (the Russian financial crisis) mess would not have happened."

Likewise, all of the uncertainty Freddie and Fannie now face cannot be blamed on outside forces, like Congress, HUD, or incorrectly interpreted statistics. I agree with Chairman Greenspan when he said:

75 "The history of financial involvement in increasing home ownership is one of taking risks - of designing new financial instruments and financial products to make financial resources available so that more people can realize the goal of home ownership. Taking prudent risks in lending so that others may attain an objective is the essential role of a financial intermediary..."[9] I suggest the GSE's renew their involvement in the home ownership process by designing new financial products tailored to the needs of homebuyers in the lower end on the market, enabling and facilitating others as they take the prudent lending risks outlined above.

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[6] "Security Backed Exclusively By Minority Loans," American Banker Newspaper, Friday December 2, 1994, Page 10.
[7] G.E. Capital is no longer in the residential mortgage business.
[8] Both Fannie Mae and Freddie Mac have received numerous corporate citizenship awards, such as: "Fannie Mae - Best Company to Work for in Washington, D.C., Metro Area, *Washingtonian Magazine* - November 1999, "Fannie Mae – One of the 100 Best Companies for Working Mothers," *Working Mothers* - September 1999.
[9] These quotes are taken from comments made by Chairman Alan Greenspan at The Social Compact Awards Luncheon, San Francisco, August 1995.

Both Freddie and Fannie dispute the HUD numbers. I expect the debate concerning GSE performance in this area to be a lively one. However one views the statistics, I think we can all agree that much remains to be done in this sector of the home mortgage market.

Other Concerns

It is certainly appropriate for Congress to review both GSE financial performance and their public mission performance. It is, therefore, important that GSE management understand Congress has a legitimate role in reviewing their activities, both from the standpoint of financial safety and soundness and with respect to the performance of the GSE's in carrying out the public mission for which they were chartered. I note that the Chairman has been examining GSE activities since at least 1996.

H.R. 3703
Mr. Chairman, I would now like to turn to your legislative proposal.

Promoting Private Market Discipline
I support repealing the GSEs' conditional line of credit with the Treasury. I agree with Treasury Under Secretary Gary Gensler when he stated, in testimony on March 22, 2000 before this Committee, that: "Repeal of the line of credit would be consistent with the congressional requirement that all GSE securities carry a disclaimer that they are not obligations of the U.S. government."

Increasing Transparency
I support provisions in the bill that increase transparency. I support provisions in the bill that require the GSE's to receive an annual credit rating from nationally recognized statistical rating organizations. Such an examination would significantly improve transparency by providing an independent and objective opinion concerning the GSE's financial condition.

I also suggest that the GSE's be subject to a "Social Audit." A Social Audit is an examination of the performance of an enterprise relative to certain social objectives. The GSE's are currently subject to a limited social audit: central city and minority lending goals have been established and progress GSE's make in meeting those goals is reviewed annually. I am suggesting, however, that the GSE's be subject to a more detailed and rigorous social audit covering all aspects of their operations. Congress may want to specify, in detail, which social objectives should be measured.

For the GSE's the major benefits of a social audit are:
- Improved accountability with respect to social and community investment activities
- Increased social efficiency and effectiveness
- Increased ability to effectively monitor and steer social performance
- Social achievements reported in an unbiased manner

Promoting Market Competition

I support provisions in the Bill to further encourage market competition.

Structural issues

I support the creation of a fully independent GSE regulator. I further suggest this regulator not part of the executive branch. As an alternative, the Chairman may wish to consider designating the Federal Reserve Board the primary GSE financial institution regulator.

I believe the Fed will, one day soon, need to oversee the activities of banks, thrifts, pension funds, insurance companies, mutual fund companies, brokerage firms and investment banks. Recent advancements in financial and computer technology require the creation of such a strong central bank.

Role of the Executive Branch in regulating GSE's.

I strongly suggest that the Executive Branch's role in regulating GSE's be limited. Recent incidents suggest that political interference may limit Executive branch regulatory effectiveness and objectivity. I refer the Committee to one such incident:

"A top federal bank regulator, responding to concerns over possible political interference in bank examinations, has ordered his staff to quit fielding a list of friendly bankers to support a controversial fair lending law.

John D. Hawke Jr., acting Comptroller of the Currency, told his staff in a memo issued Friday that bank examinations must be 'kept completely free from even the appearance of being influenced by political considerations.' The comptroller, an arm of the Treasury Department, regulates 2,600 national banks."[10]

We have observed this type of inappropriate behavior before, preceding the S&L Crisis of the 1980's, and more recently, with the Community Development Financial Institution program, a financial institution program administered by the U.S. Treasury. According to the House Banking Committee:

"$37 Million Clinton Inner-City Loan Fund in Disarray and subject to Political Cronyism. 1 in 3 Grants To First Lady's Favorite.

A $37 million Clinton Administration campaign centerpiece designed to overcome perceived inequities in bank lending to poor and inner-city clients appears to be in disarray, is without adequate standards for making grants, and has at least the appearance of conflicts of interest that 'raises questions concerning the fairness of the system,' a senior House Banking Committee member said today."[11]

In this case, critical federal assistance and funding was determined to have been distributed, in part, based on political ties and not on efficiency, market requirements, performance or need. Given this, I believe making an executive branch agency the chief GSE institution regulator may have harmful consequences. The Federal Reserve System, an independent body, is not subject to and has not been shown to engage in this type of politically biased regulatory interference

Conclusion

In an interdependent financial world, with capital and information flows often determining the short-term fate of nations, it is entirely appropriate for this committee to review the proper role and function of the GSE's. Given the speed with which capital market destabilization can occur, as shown during the Long Term Capital Management (LTCM) incident, the creation of a strong, unbiased, and politically independent GSE regulator is essential.

As many who have come before this committee have noted, domestic housing finance markets are currently broad and well functioning. These markets have been the beneficiaries of an unprecedented increase in financial market activity and asset values. GSE shareholders have profited greatly as a result. Now is the time to review GSE financial and social performance. By so doing, we are likely to insure that GSE shareholders continue to prosper and the nation continues to enjoy the world's best housing finance markets.

This Committee has done this country a great service by focusing public attention on the GSEs. In this way, the Committee continues to meet its obligation to enhance the long term stability of the U.S. financial system. I applaud the Committee for doing so in a balanced, thoughtful manner.

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[10] *Complaints Prompt U.S. Bank Regulator to Warn Staff on Contacts*. By Robert Wells. Washington, Feb. 8, 1999. (Bloomberg)

[11] Press release from the U.S. House Banking Committee, issued by U.S. Representative Spencer Bachus, (AL - 6th.) Dated May 15, 1997. http://www.house.gov/banking/51597bpr.htm.

Statement of the Honorable Walter E. Fauntroy

Before the House Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises

June 15, 2000

Thank you Chairman Baker, Ranking Member Kanjorski. It is good to be back here in this very familiar room and to see so many familiar faces. I came to the congress in 1971 and spent the better part of the next twenty years helping to shape landmark legislation in the field of Banking, Finance and Urban Affairs. I was for six years chair of the subcommittee on Domestic Monetary Policy and for another four years chair of what we called the subcommittee on International Development, Finance, Trade and Monetary Policy.

Most important, I brought to the committee the valuable experience of having conceived and carried out a unique national demonstration project right here in our nation's capital that coordinated and concentrated all available federal and local programs in a very successful effort to both rehabilitate and build anew affordable housing for the low and moderate income families of the city. It was a project that enjoyed the bipartisan support of both the Johnson and Nixon Administrations. I'd like for you to take a look at a front page story that appeared in the Washington Post back in 1966 announcing the project, and also an article done by Mary McGrory, then with the Washington Star newspaper, that appeared four years later applauding the pivotal role that President Richard Nixon played in a truly bipartisan effort to address the crisis we were experiencing at that time when the stock of affordable housing for low and moderate income housing was rapidly disappearing.

That was thirty years ago. I am here today, Mr. Chairman and members of the committee, because of a single disturbing trend in the nation that reflects itself most acutely right here in our nation's capital, and that is that, despite the booming economy, worst case housing needs are more severe today than they were when that last noble bipartisan effort rescued thousands of District of Columbia families from homelessness. In the last two years, our Section 8 waiting list in the District has increased by 29%, our public housing waiting list by

24%. Time on our waiting lists for both Section 8 and public housing is up to five (5) years. The national average for waiting time is eleven months.

Let me refer you to HUD's most recent Report to Congress on Worst Case Housing Needs, published in March of this year. It informed you that worst-case housing needs reached an all-time high of 5.4 million households and that there are now 600,000 more worst case households today than there were in 1991 when the current economic recovery began – a rate of increase that is almost twice as fast as overall household growth.

That, Mr. chairman, is precisely why I have requested this opportunity to appear before the Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises on H.R. 3703. For as bad as things are today, we would be infinitely worse off had it not been for the wisdom of the Congress in focusing our housing GSEs more sharply on the task of providing access to affordable homeownership, and providing a regulatory structure to assure that that mission is accomplished.

I recall so very well the energy and effort that committee members put into fashioning the 1992 Act that modified the GSEs' charter. This Act, among other things, created the GSEs' affordable housing goals, strengthened HUD's role as the GSEs' mission regulator, and created a system and a regulator for ensuring these companies continued to be financially safe and sound.

I have spent the years since that time organizing a variety of economic and community development initiatives among the more than 200 national African American organizations that make up the national network vehicle of the Congressional Black Caucus that I head, the National Black Leadership Roundtable. I can report to you, without fear of successful contradiction, that the foundation that we created in the 1992 Act has provided a platform for success and accomplishment and for helping many groups of people who need help the most. Fannie Mae and Freddie Mac are looking at housing activities that support healthy community and economic development in ways that they did not prior to the 1992 enhancements. They are meeting and surpassing their housing goals and providing investment and support for much of the housing development that has taken place since 1992.

In Washington DC and in communities throughout the country, these mission-driven companies have helped harness private capital and direct it toward fulfillment of the American dream of homeownership. Let's look at some of the facts:

- Today, our national homeownership rate stands at an historic high of 67%.
- In 1993, Fannie Mae served 35.6% of families with low- and moderate-income. Today, under goals set by HUD, 50% of Fannie Mae and Freddie Mac's business must serve low- and moderate-income families, and I will be watching to make sure that they really do meet this goal.
- A little closer to home, here in DC, the homeownership has risen to 42%. While that needs to be a lot higher, it sure represents a lot of progress.
- Minority homeownership during the 1990s grew tremendously. That's not to say that much doesn't remain to be done on minority homeownership. The African-American homeownership rate today is over 47% (up from 42% in 1993), and the Hispanic homeownership rate is close to 46% (up from 39% in 1993) -- but the white homeownership rate is over 73%.
- Our GSEs are part of the answer to narrowing the homeownership gap and raising the rate of minority homeowners.

These are significant results, and these are results that should not be taken lightly or dismissed. Any effort to reform or change the current structure and the role of Fannie Mae and Freddie Mac must look at the huge benefits these companies provide to Americans, and the costs "reforms" would mean to homeowners. Because there aren't as many people in the African American community who own houses, my community would be hit the hardest. And, that is why I have asked for the first time since I left the Congress to testify before the committee on which I gave twenty years of my life as a member. Simply put, Mr. Chairman, this proposed bill would raise the costs of homeownership. These are costs that already are too high for many people in our minority communities.

I would like to take a moment to challenge some of the points made by critics of the GSEs. There are those who assert that the GSEs should no longer exist -- that whatever

market failure they were originally created to address has been remedied, and that the "private market", without the GSEs, can fully meet the housing finance needs of our country. I don't believe that for a minute. There is a reason why Congress – why this Committee – has seen the need to enact laws like the Community Reinvestment Act. It is precisely because this so-called "private market", left to its own devices, will not serve certain segments of our communities – segments where it is perceived that the risks are too high and the returns too low. This is not to say that everyone can and should be a homeowner – it is just that Congress has determined that it is appropriate to create additional incentives and structures to push the market to do more and to recognize the business opportunities of non-traditional markets.

Mr. Chairman, I've heard complaints about Fannie Mae and mission creep, and pointing to home equity loans as an example.

Let's face it, today's fancy term "home equity loan" was and is a second mortgage. At least that's what we called it in 1984, when I was here and this committee explicitly added second loans or home equity loans to the list of products we wanted Fannie Mae to buy. We did this because it meant that second mortgages, which lenders priced way above first mortgages, would come down in price. And that is exactly what happened.

Mr. Chairman, somebody is trying to fool this subcommittee. It is the people who say that purchasing home equity loans is outside of the GSE charters.

This is not true – as we set it up, as long as it is a mortgage home loan below the conforming limit, Fannie and Freddie can buy them. A home mortgage loan is any loan for which the house or equity in the house is security. Congress gave Fannie and Freddie authority to be in that market and I expect that means that prices for those products are being made cheaper for consumers all across the country. That's good!

But promoting affordability is not the only good that is coming of this—these companies are developing unique ways of helping homeowners. Reverse annuity mortgages—with adequate consumer safeguards—that help the elderly tap the equity in their home while they continue to live out their lives there. Home improvement loans that help consumers maintain

and improve their homes. One of the ideas that these business interests are criticizing is a partnership between a lender and Home Depot. I'm particularly supportive of that idea; it helps the average borrower get decent financing and makes sure that the home improvement work is done by a reputable contractor. It keeps consumers out of the hands of the fly-by-night operators who work hand in hand with predatory lenders.

Predictably Mr. Chairman, many of the complaints against Fannie and Freddie are being brought by business competitors who call themselves "the private sector," and who try and draw some mythical distinction between how they get their working capital and how Fannie and Freddie get theirs.

As a Member of Congress, I always smiled when those folks would visit me on this subject. They have access to cheaper working capital because of federal deposit insurance (for which they do not pay), access to the federal home loan bank advance system, and the advantages of the Federal Reserve System—but they call themselves private while claiming that Fannie and Freddie are part of the government.

As I said earlier, I was for six years chair of the House Banking Subcommittee on Domestic Monetary Policy. Paul Volcker taught me then what Alan Greenspan confirms even today. He says that commercial banks and thrifts have a "13 basis points subsidy" from the federal government. That's a pretty good authority, Alan Greenspan. So if Fannie and Freddie have, as some believe, an "implicit benefit from the government, which even CBO claims is largely passed onto consumers, how much of the very real bank subsidy Mr. Greenspan talked about gets passed on?? I suspect very little, Mr. Chairman. But, that would be an interesting question for the Congressional Budget Office to answer.

Mr. Chairman, I know that some of the witnesses today will challenge Fannie Mae and Freddie Mac's entry into the subprime market. It is important, as many on this subcommittee know, to draw a distinction between "subprime" lending and "predatory" lenders. Subprime lending can legitimately serve the needs of borrowers who have had some credit problems in the past. Predatory lending—either through pricing loans with very high interest rates or

engaging in practices that ultimately rob homeowners of the equity in their homes--is very bad! It is destroying many people in the communities I work with – and it must be stopped.

I expect that Fannie Mae and Freddie Mac will help be a solution to the predatory lending problem. They can do this by identifying huge numbers of people who deserve to be in the "A" market and rescuing them from having to pay more for their mortgage loan—this is a valuable service for them to perform, using market forces. They will also rescue people with only slightly impaired credit, who are now paying a lot more for mortgage loans over what lenders can offer these same borrowers using the new products that Fannie and Freddie have developed to help these people.

To those who claim that this market will stump Fannie Mae and Freddie Mac and cause huge losses, I say sit back and watch. Fannie Mae and Freddie Mac are the best risk managers on the planet. Not only are their credit losses low—but also they have been leaders in helping their lenders work with borrowers who are in trouble, so that these lenders forbear on delinquent loans and develop workout plans. That's why their losses are so low—they know how to manage risk up front and they know how to manage risk when the going gets tough. And this good work helps keeps people in their houses, which helps keep a community strong.

Most of the complaints about Fannie and Freddie entering the subprime markets are not coming from regulatory authorities--HUD wants them to go there—but from the companies who have been overcharging millions of American families. And, many of those people being overcharged by these companies are minority families who cannot afford to be overcharged.

Every Member of this subcommittee has been around long enough to know that "follow the money" is always a good thing to do when one group is asking Congress to do something to another group. Congress chartered Fannie Mae and Freddie Mac we knew we were doing that to make housing more affordable for consumers—we weren't doing that to divide the market up between various players.

I hope this committee remembers that and takes great care not to do anything that will limit the ability of Fannie and Freddie to come up with new products that help meet local needs.

I hope the members of this committee don't listen to those strange allegations about "mission creep" – Fannie Mae and Freddie Mac have a big mission and they are working hard toward that mission. This committee gave them a charter telling them what they can do and they are simply moving forward to meet their mission. They are moving – but not outside that Charter. Congress must be careful to not set up a regulatory process that will make it hard for Fannie Mae and Freddie Mac to keep on moving toward that mission. I have to say that I find it strange that the chief sponsors of this bill believe more regulation and more government intervention makes for a better mortgage market and lower costs to homeowners.

I am especially proud of the good work that the companies are doing to work with a wide variety of groups to help meet the needs of the communities that need help the most. For example, through their national Faith-Based Initiative, Fannie Mae is forming a broad network of lending and community partners who share their commitment to increasing homeownership opportunities for their communities. Through partners like the Congress of National Black Churches, they are working to ensure that faith-based communities receive homebuyer education, credit counseling, and mortgage financing. Additionally, Fannie Mae is working with their faith-based partners to increase their capacity for housing development through training, technical assistance, and investments.

I am not an expert on all the many details of the legislation that is the subject of this hearing. But I do know that this legislation goes beyond simply making a few changes to the regulatory structure. This legislation strikes at the heart of what has allowed Fannie Mae and Freddie Mac to bring the full force of their resources to address housing problems in America. If this legislation diminishes the ability of Fannie Mae and Freddie Mac to remain healthy and to grow and innovate, then they will not be able to devote as many resources as they currently do to meet their mission—which serves a mission that is more important today than at any time they were established..

If this legislation affects their ability to make investments or do their business in the best way their experts see fit, then that weakens all of our efforts to address the worsening crisis called to our attention by HUD in its Report To Congress this year. Increasing restrictions on the business decisions that Fannie Mae and Freddie Mac are so good at will make it harder for

them to work with those across our nation who are striving to meet this present crisis. This would hurt every community across this country.

This legislation should not be a tool for those in the marketplace who are profiting from the status quo and who oppose expansive lenders into areas of their business—like high priced subprime lending or rehabilitation lending—where Fannie Mae and Freddie Mac can bring consumer protections and make things more affordable. Right now, the people in my community suffer from the status quo that keeps the price of these loans high – I want Fannie Mae and Freddie Mac to help make those problems go away.

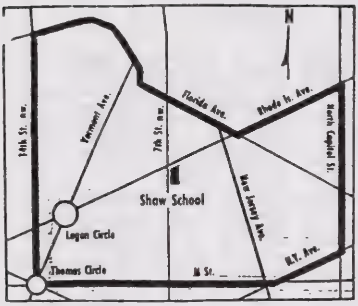
Throughout my career, Mr. Chairman, as a local pastor for more than forty years, as a national civil rights activist with Dr. Martin Luther King, Jr. and as a substantive member of this Congress for twenty years, I have never been content to just oppose measures; I have always balanced my opposition with the proposition of a better way. I did not simply oppose urban renewal as "urban removal;" I proposed a new kind of renewal, "with, buy and for the people;" and both President Johnson and President Nixon bought into the idea. I did not just oppose the civil rights wrongs of the decade of the sixties, Dr. King and our movement proposed a better way that the congress and the American people bought into in the Civil rights Act of 1964 and the Voting Rights Act of 1965. I did not simply oppose Apartheid in South Africa; our Free South Africa Movement and millions of Americans of goodwill proposed a nonviolent means to end it. I was here when the congress on a bipartisan basis bought into that proposal.

Even as I oppose further consideration of H.R. 3703 by the subcommittee, therefore, I want now to propose a better course of action. As I pointed out earlier, the problem of a rapidly disappearing stock of land and housing for low-income citizens reflects itself most acutely right here in our nation's capital. I want to propose that members of the subcommittee join ranking member Paul Kanjorski and me on a bipartisan basis in an exciting national demonstration that is about to commence at the request of a faith-based organization that it is my privilege to head. It is a partnership made possible by your passage in 1998 of the **Asset Control Area Partnership Act** which creates a new way of revitalizing neighborhoods, one that creates decent housing through federal/local govern partnerships with faith-based institutions to efficiently dispose of HUD-owned single family homes.

The Fund for Affordable Innercity Turnkey Housing (FAITH), which I chair, has proposed a Neighborhood Revitalization Partnership anchored by HUD that includes the District Government, Fannie Mae, Freddie Mac and Bank of America among other banks in the District of Columbia to buy, rehabilitate and sell to qualified low/moderate income homeowners all of the HUD owned and District owned single and multi-family family homes located in D.C. As an instructive example to the rest of the nation, we intend to integrate and concentrate all available federal and district government housing programs into a comprehensive approach to solving the present crisis called to our attention by HUD this year. With your help, I believe it will be even more successful than the magnificent bipartisan effort put together by Presidents Johnson and Nixon thirty years ago.

I am looking to both Freddie Mac and Fannie Mae to partner with us, using this faith-based program to make my vision for this project a reality. When I go to Fannie Mae to do business, I feel very at home because so many of their employees, not just their chairman and CEO, are also African-American. I note this because those who claim Fannie Mae is not helping Black and Brown America are playing fast and loose with the facts, twisting numbers, and playing games. I urge this committee to look at the forest and all of those trees.

With your permission, Mr. Chairman, I would like to make part of my testimony the letters from The Honorable Johnny Ford, Mayor of Tuskegee, Alabama and The Honorable James L. Thomas, President of the National Black Caucus of State Legislators, both members of our National Black Leadership Roundtable. These letters state their support of Fannie Mae's efforts to remove remaining barriers to homeownership and to bring even more families closer to the realization of the American Dream.



The Washington Post April 8, 1966

AFFECTED—This is the Shaw urban renewal area.

Shaw Area Will Launch New-Style City Renewal

By Wolf Von Eckardt
Washington Post Staff Writer

Led by the Rev. Walter E. Fauntroy, the people of the Shaw Junior High School area, one of the city's worst, propose to launch a comprehensive assault on human despair and physical decay.

The National Capital Planning Commission yesterday unanimously aproved the concept. It declared the turbulent second and parts of the thirteenth police precinct with its 40,000 largely low income Negro residents an "urban renewal area."

But this is to be a new kind of urban renewal.

As Mr. Fauntroy, a soft-spoken but often militantly outspoken civil rights leader and pastor of New Bethel Baptist Church puts it, the attack "would coordinate and concentrate all available Federal resources — in housing construction, job training, health, recreation, welfare, education, transportation and municipal services — to improve both physival and social conditions for the people who live and work there."

The "Shaw inner city model program" as Mr. Fauntroy calls it, is similar in concept to President Johnson's "demonstration cities" program. The Planning Commission agreed that it is to be planned and carried out with the participation of the residents.

At present there are available more than 40 Federal urban assistance programs that the effort hopes to draw on. They range from urban renewal and low-rent housing to maternal and child health care and war on poverty job training and other efforts.

The "demonstration cities" proposal, now being considered in Congress, would offer special supplemental grants to cities that concentrate existing programs on a single area and under a comprehensive plan so that they show tangible results. The grants are for up to 80 per cent of the city's share of the total cost.

Mr. Fauntroy has quietly worked for the past few months both in the neighborhood and with city authorities to win support and approval for the "model inner city" concept.

By Norman Driscoll, Staff Photographer

LEADER—The Rev. Walter E. Fauntroy, militant civil rights leader, stands in front of Shaw Junior High School, hub of a Northwest Washington area that is to be subjected to urban renewal. Map, another picture, A8.

See SHAW, A8, Col. 3

Approval of Training School site for new GPO is revoked. *Page B1.*

Revised National Square design draws high praise. *Page B3.*

By MARY McGRORY

Fauntroy and Nixon

Three months ago, it would have been hard to find in the Republic two men who more deeply disapproved of each other than Richard M. Nixon and the Rev. Walter Fauntroy.

Now, of course, they are going forward together to marvelous mutual advantage, one having found a witness and the other a sponsor.

Of the pre-inaugural Nixon, Fauntroy, pastor of the New Bethel Baptist Church, was, he says, "scared to death — the friend of Strom Thurmond, you know, insensitive to our problems."

Nixon's antipathy to Americans who take causes to the streets was a major theme of his campaign, and Fauntroy, although a gentle soul who wears a Boy Scout insignia in his lapel, is a veteran of Selma, Montgomery, Resurrection City and innumerable other open-air protests.

Fauntroy started out being a political problem to the Nixon administration. Hardly had the ballots been counted on Nov. 5, when Washington Republicans began beating on their new leader to get Fauntroy off the District of Columbia City Council.

Fauntroy's activities as vice chairman were not the issue. But local burghers considered his extra-curricular exertions for the militant Black United Front, which was founded by Stokely Carmichael, and for the non-violent Southern Christian Leadership Conference an outrage.

But by the time the Nixons had moved into the White House, Fauntroy had been rediscovered as a prime political asset for a Republican President with no black friends.

It was not the man but his plan that caused the transformation. For Fauntroy had a total project, ready to go, an urban renewal scheme "for, by and with" the residents of Washington's Shaw area. These 145 blocks are a prize exhibit in urban decay: 45,000 people, 90 percent of them black, jammed into 13,000 housing units on land that is 70 percent owned by absentee landlords.

"In effect, a plantation," says Fauntroy. "Not one public library, not one swimming pool."

With generous assists from Great Society programs, Fauntroy in 1966 formed the Model Inner City Community Organization, a non-profit corporation, which recruited black architects and black planners, and trained black workers from local dropouts between the ages of 17½ and 24 — "the guys who are doing the sticking-up."

Its main features of housing, education, transportation and recreation were incorporated from suggestions invited by teams of surveyors made up of neighborhood people and Howard University students.

For Nixon, who knew he must speak to the blacks through action, it was a setup, a demonstration of good will toward the blacks and the cities and a pilot model of the "black capitalism" of the campaign.

Fauntroy, who has naturally undergone a change of heart about the President, says, "The devil himself would have taken this plan."

The first inkling he had that his Utopia would be promoted by the White House came on Jan. 22, when Deputy Mayor Thomas Fletcher reported after a meeting with Daniel P. Moynihan, the President's urban adviser and another nonhero to the black community, "Moynihan says he wants to go with Shaw, start with the burnt-out corridors."

On Jan. 28, the City Council approved the plan, and, says Fauntroy, "within 24 hours they had cut through six months of work and we had $30 million."

Three days later, Fauntroy found himself in the middle of Shaw, Richard Nixon by his side and the natives cheering out front, and himself trying to thank the President for making his dream come true.

By the end of the year, 1,000 new housing units will be built in Shaw. The fears of "urban removal" fanned by local poverty program workers who fought the plan have been stilled. No one will be dislocated, because the first buildings will go on sites burnt out during the April riots.

The story of Shaw seems to have a happy ending for everyone. The Republicans are happy that Fauntroy will be off the council. He is leaving to devote full time to Shaw and already hoping to persuade the President to start Shaws in 15 other cities. The President, of course, is happy to have acquired an ideal ambassador to the black community, a militant but boyish clergyman, a reformer with a blueprint. Fauntroy is "floating."

His flock are still dubious, as are their soul-brothers around the country. "They will change when they see those first pictures of former dope addicts laying brick," he promises.

THE NATIONAL BLACK CAUCUS OF STATE LEGISLATORS

Rep. James L. Thomas, AL
President

June 14, 2000

The Honorable Walter E. Fauntroy
President
National Black Leadership Roundtable
1025 Connecticut Avenue, N.W., Suite 415
Washington, DC 20036

Dear Reverend Fauntroy:

The National Black Caucus of State Legislators would like to support your testimony before the Capital Markets Subcommittee on Thursday, June 15, 2000. As you know, our membership includes African-American legislators from nearly every state in America. Our constituents are those most in need of the innovative products and liquidity that Fannie Mae brings to the mortgage finance industry.

During the last decade, homeownership rates have risen to record levels. I believe Fannie Mae played a significant role in this nationwide increase and deserves credit for helping millions of families attain homeownership. However, there is a great deal more to be done. A legislative proposal like H.R. 3703 would seriously impede future progress. We urge you to oppose its enactment. We applaud Fannie Mae's efforts to remove remaining barriers to homeownership and bring even more families closer to the realization of the American Dream.

I continue to be impressed with Fannie Mae's ability to identify underserved communities and its efforts to provide them with greater access to mortgage funds. I am confident that Fannie Mae's efforts will have a profound and positive impact on our nation as a whole as communities are strengthened through homeownership.

The National Black Caucus of State Legislators looks forward to working with you and we pledge our support for your efforts at continuing to make the dream of homeownership a reality.

Sincerely,

James L. Thomas

James L. Thomas
President, NBSCL
Alabama House of Representatives

444 N. Capitol St., NW · Suite 622 · Washington, DC 20001 · (202) 624-5457 · Fax (202) 508-3826 · www.NBCSL.com

WCM

WORLD CONFERENCE OF MAYORS, INC.
(United Nations of Cities)

HON. JOHNNY FORD, Founder, Director General
Tuskegee, AL (USA)

June 14, 2000

The Honorable Walter E. Fauntroy
President
National Black Leadership Roundtable
1025 Connecticut Avenue, N.W., Suite 415
Washington, DC 20036

Dear Reverend Fauntroy:

The World Conference of Mayors represents over four hundred African-American Mayors, and we share your views regarding the critical importance of homeownership for our constituents. We know that the linch pins of our communities are the family, Church, and homeownership. The basis of economic prosperity is homeownership.

We have seen first hand in our communities that Fannie Mae's focus on increasing homeownership among minorities, young families, women-based households, new immigrants, urban and rural dwellers, and others whose homeownership rate lags the general population and who did not benefit fully from the economic expansion of the past ten years are efforts that must be encouraged and supported. For this reason, the World Conference of Mayors applauds your testimony before the Capital Markets Subcommittee on Thursday, June 15, 2000, in support of Fannie Mae's partnering with cities, communities and church-based organizations so that we can all work together to build wealth and savings among millions of families, stabilize neighborhoods, and

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eradicate discrimination and unfair practices in the mortgage marketplace.

Moreover, we oppose legislation that places the impediments of prior approval in the way of homeownership and we oppose coalitions, whose only mission is to raise the cost of a home to our constituents.

We support your appearance before the subcommittee because we share your views. Views that expand affordable housing opportunities strengthen communities and build hopes and dreams for all Americans.

Sincerely,

Johnny Ford
Founder and Director General

APPENDIX

June 21, 2000

PAUL E. KANJORSKI
11TH DISTRICT, PENNSYLVANIA

COMMITTEE ON BANKING AND FINANCIAL SERVICES

RANKING MEMBER
SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES AND GOVERNMENT SPONSORED ENTERPRISES

COMMITTEE ON GOVERNMENT REFORM

DEMOCRATIC WHIP AT LARGE

Congress of the United States
Washington, DC 20515–3811

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SUITE 400 M
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KULPMONT MUNICIPAL BUILDING
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(570) 373-1541

TOLL FREE HELP LINE
(800) 222-2346

OPENING STATEMENT OF
RANKING MEMBER PAUL E. KANJORSKI
SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES, AND GOVERNMENT SPONSORED ENTERPRISES

HEARING ON H.R. 3703,
THE HOUSING FINANCE REGULATORY IMPROVEMENT ACT

WEDNESDAY, JUNE 21, 2000

Mr. Chairman, this is our fourth day of hearings on H.R. 3703, the Housing Finance Regulatory Improvement Act. During my opening remarks at our previous hearings, I have noted — and I will continue to note — that we must move forward cautiously and carefully in our consideration of this legislation. We must ensure that we do not accidentally raise homeownership costs, and we should not attempt in any way to legislate this year. We should, however, continue to use your bill, H.R. 3703, as a focus for our Subcommittee's legitimate oversight activities.

At last week's hearing, I also noted that in order for our oversight to be fair and effective we must ensure that our hearings are well crafted. Comprehensive hearings and ideally roundtables will help us to meticulously debate the costs and benefits of H.R. 3703 and allow us to vet more thoroughly the many issues associated with the mission compliance and safety and soundness regulation of the housing government-sponsored enterprises or GSEs. I am, therefore, pleased that former Congressman Walter Fauntroy will testify at length before us today. He brings a wealth of knowledge to these matters, not only from his nearly 20 years in Congress, but also from his own personal efforts to create affordable housing.

If we continue to hold hearings on GSE regulation, I hope that we will increasingly work together to ensure that our panels are more and more balanced in their construction. Additionally, to improve the quality of today's proceedings, I would request unanimous consent to submit for the record some of the many letters that I have received from community advocates and affordable housing groups in recent days. These letters come from a variety of viewpoints and represent a broad, cross-section of the country.

During the last week, taxpayer risk has been the subject of considerable debate not only in our Subcommittee, but also in the corridors of Congress. For example, we almost considered H.R. 21, the so-called Homeowners' Insurance Availability Act, on the House floor. Fortunately, the leadership pulled this troubling legislation from the schedule. If we had considered the bill, however, and if it had passed, we could have unwisely exposed taxpayers to billions of dollars in liabilities. The easiest way to avoid risk for the taxpayers is to never start. Accordingly, I am pleased that each of the witnesses on our first panel strongly supported my efforts to defeat H.R. 21, and I look forward to hearing from each of them today.

Additionally, last night we debated an amendment on the House floor to provide the Office of Federal Housing Enterprise Oversight with its full budget request for fiscal 2001. During our hearings to date on H.R. 3703, I believe we have reached consensus on two points. First, we can agree that we have the world's most successful housing finance system. Second, we can agree that we must have strong, independent regulators for the housing GSEs. It is crucial that OFHEO have sufficient capacity to fulfill its safety and soundness regulatory responsibilities. Therefore, when we vote later today, I hope that all of my colleagues on both sides of the aisle, and especially the Members of this Subcommittee, will support the Hinchey amendment to provide OFHEO with the resources it needs to get the job done.

In closing, Mr. Chairman, I look forward to today's examination of not only how we might consider improving the efficiency and effectiveness of our GSE regulators, but also how we can work together to lower homeownership costs for all Americans.

Congress of the United States

Washington, DC 20515

June 9, 2000

Franklin D. Raines
Chairman and Chief Executive Officer
Fannie Mae
3900 Wisconsin Avenue, NW
Washington, D.C. 20016-2892

Dear Mr. Raines:

We are writing to express our great displeasure with Fannie Mae's failure to provide us with the additional information Members of our subcommittee requested regarding the recent "astroturf" lobbying effort. As Members of the Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises, the committee of jurisdiction over Fannie Mae, we remain concerned about:

1) the appropriateness of how the campaign was conducted;
2) the misleading way the information was presented in both the script and the telegram;
3) the significant number of our constituents who claim they were not contacted or did not agree to have their names used;
4) the volume of resources used to conduct the campaign;
5) the failure of Fannie Mae to provide us with the contract into which Fannie Mae entered with International Data Management, Inc. to carry out the campaign by claiming the contract is proprietary; and
6) the wisdom of engaging in such a campaign in the first place.

Upon reviewing the "Proprietary Information" clause in the "standard" Fannie Mae contract, we do not see any language that declares the cost of the contract or the contract itself proprietary information. As such, we demand that a copy of the contract into which Fannie Mae entered with International Data Management, Inc. be provided to us prior to the June 15, 2000, subcommittee hearing.

We believe that we have the right and the responsibility to raise questions about government sponsored enterprises (GSEs) and the way they conduct their businesses. We have no desire to pass legislation that will raise the cost of homeownership. However, this subcommittee is charged with the responsibility of making sure that GSEs accomplish the purposes for which they exist and do not pose an unnecessary threat to the American taxpayer. Furthermore, we expect that we be allowed to conduct our responsibility without being inappropriately lobbied. As long as Fannie Mae remains a quasi-governmental agency under the jurisdiction of this subcommittee, we will continue to review the activities of Fannie Mae and implement changes whenever necessary.

We sincerely hope that Fannie Mae will rejoin this debate in a constructive way. We recognize the contributions that Fannie Mae has made to American homeownership over the last few decades. While there will certainly be provisions in legislation upon which we will have to agree to disagree, we would like to continue this debate in a civil, responsible, and respectful way.

Sincerely,

Richard H. Baker
Member of Congress

Donald A. Manzullo
Member of Congress

John E. Sweeney
Member of Congress

Judy Biggert
Member of Congress

FannieMae

Franklin D. Raines

Chairman and
Chief Executive Officer

3900 Wisconsin Avenue, NW
Washington, DC 20016-2892
202 752 7380
202 752 5980 (fax)

June 14, 2000

The Honorable Donald Manzullo
U.S. House of Representatives
Washington, D.C. 20515

Dear Congressman Manzullo:

I have received your letter of June 9, 2000, in which you asked a number of questions about our efforts to contact homeowners regarding H.R. 3703. Since the May 16 hearing, we have been in contact with the several Congressional offices that expressed concern about this effort, and I want to respond again to every question you have raised.

First, you asked about the appropriateness of how this effort was conducted. We intended it to demonstrate the positive support for homeownership in your district and to express a concern about any legislation that would undermine the affordability of homeownership. I regret that this effort, partly due to our failure to notify in advance your office and those of a few other Members, has caused such consternation among some Members of the Subcommittee. For that, you have my sincere apology.

I communicated our position on H.R. 3703 at the Subcommittee hearing on May 16. As I made clear in my testimony, we believe that this bill, if enacted, would increase the costs of homeownership and damage the housing finance system that has worked so well for millions of Americans. I tried through my statements to present that case in some detail and respond to every question posed by Members of the Subcommittee.

Second, you asked about information that you said was presented in a misleading way in the calls to homeowners and in the telegram. In fact, the purpose of this effort was to communicate the same message I delivered to the Subcommittee on May 16. My purpose in responding to your letter as quickly as possible is to make sure that you understand why we decided to contact homeowners directly to seek their support, how the effort was conducted, and what quality control elements we put in place to ensure that our message was communicated clearly and accurately.

In the two lengthy briefings that senior officials of Fannie Mae have held in the last few weeks with the staffs and a Member of the Subcommittee, we provided detailed

information about the purpose of this effort and precisely how it was conducted. Fannie Mae has had an ongoing business relationship with International Data Management, Inc. (IDMI), a data management company, and in April of this year we asked them to help us communicate to homeowners our concerns about legislation pending before the Subcommittee.

IDMI subcontracted with two telemarketing firms, Infocision and Incept Corporation. The calls to consumers specifically identified Fannie Mae as the sponsor of the call and noted that the company encourages Americans to speak out on policy issues that directly impact homeownership. The calls also noted that the Subcommittee is considering a bill that would increase the costs of homeownership, and asked each homeowner if Fannie Mae could include the homeowner's name on a telegram to their Member of Congress asking the Member to oppose this legislation.

Fannie Mae wrote the text used to make these calls, and we have provided the text to all of the Members of the Subcommittee who have asked us about this effort. In the more than 45,000 cases in which the homeowner allowed us to send a telegram on their behalf, we either mailed a copy of the telegram to the homeowner or e-mailed a copy to the one-third of all homeowners who agreed to send a telegram and who provided us with their e-mail addresses. The telegram begins by thanking the Member of Congress for their efforts to assist homeowners and homeownership.

Third, you asked about constituents you contacted who said they did not agree to have a letter sent on their behalf. I certainly understand why you would be concerned -- as would I -- if some of the people on whose behalf we sent letters did not want such letters sent. I apologize if this was the case. Fannie Mae and the companies with whom we worked on this project have put in place several layers of quality controls to ensure that homeowner responses were recorded accurately.

- We cut in half the standard 20:1 caller-to-supervisor ratio (to 10:1) so that there would be ample supervision of the calls.

- Supervisors were on site at the call center, and randomly listened to approximately 10 percent of all calls -- also high compared to industry averages.

- The role of the supervisor was to ensure that the caller was polite and respectful; identified himself or herself and for whom they were calling; accurately followed the approved text; asked the constituent if they would agree to a letter sent on their behalf to their Member of Congress (and stated the Member's name). The supervisor also checked that if the homeowner's answer was "yes", the caller verified their name and address, and thanked the homeowner for their support. If the response was "no", the caller thanked them for their time and call was terminated. The supervisor also checked whether the caller accurately recorded the result of the call.

- Both Infocision and Incept made follow-up calls to approximately 1 percent of all "yes" responses to verify the information recorded in the initial call.

- The employees making the calls were compensated based on the number of hours they worked, not on the number of homeowners who agreed to send a telegram.

I also want to emphasize that we chose IDMI, Infocision, and Incent because each firm has a long-standing reputation for high-quality work in this field. Infocision, for example, has worked for the National Republican Congressional Committee for many years, has done work this year for several Republican presidential campaigns, and is widely regarded as a quality leader in this field.

Of course, even with several layers of quality controls, it is possible that the callers incorrectly recorded some responses and that these errors were not caught. I have asked my staff to examine whether there are any additional quality control measures that we can put in place to prevent such errors in the future.

Let me make a further point on this matter. Fannie Mae in no way involved or used the name of the Fannie Mae Foundation in making these calls. Attached is a letter from IDMI that confirms this point.

Fourth, you asked about the level of resources we used to conduct this effort, and you also asked for a copy of the contract that would provide this information. Fannie Mae is legally prevented from releasing the contract we have with IDMI. To protect proprietary, confidential or trade secret information, contracting parties routinely agree to respect and protect each other's non-public information, including information about pricing. Such information is a valuable corporate asset, provides an economic advantage, and enables a party to succeed in a competitive business environment. Fannie Mae routinely requires vendors with whom we transact business to contractually agree not to disclose such information. Our counterparties in vendor contracts have similar interests in protecting their own non-public information.

Such is the case with our contract with IDMI. Both parties have mutually agreed not to disclose proprietary, confidential or trade secret information identified as such by the other party without express written consent; it is an essential element of the contract. IDMI has notified us that the contract and pricing arrangements are proprietary and confidential and that an unauthorized release of this non-public information would be a breach of the contract. Consequently, we are not permitted to unilaterally disclose the contract and pricing arrangements and must honor our agreement with IDMI. IDMI's position on release of the requested information and willingness to brief interested parties is indicated in the attached letter.

Last, you asked about the wisdom of conducting such an effort. During my testimony before the Subcommittee, I emphasized several times that the Subcommittee's review of these issues is entirely appropriate. As you state in your letter, you have a responsibility

to review the activities of GSEs, and I know, as you have made clear, that you do not want to raise the cost of homeownership.

Because none of us wants to raise the cost of homeownership, it was important that I state unequivocally my concern that H.R. 3703 would do precisely that. As Fannie Mae's chairman, I have a responsibility to oppose forcefully anything I think would undercut our ability to expand the availability and affordability of homeownership.

In the weeks before the May 16 hearing, my staff provided to all of the Subcommittee Member offices a comprehensive review of Fannie Mae's activities and responded to concerns some have raised about Fannie Mae. We also designed the project I have described in this letter to demonstrate the positive support for homeownership in your districts. Our effort stands out because it generated a stronger response than a similar letter-writing campaign generated by those on the other side of the issue. Indeed, several offices have shown us form letters generated by these groups. Because the Subcommittee has played a historic role in expanding access to homeownership, we believed our letters would have a positive impact. I regret that the letters instead provoked a negative response.

We will continue to make our case as effectively as we can to you and your colleagues. I would be troubled, however, by any implication that we should be restricted in our ability to make that case before Congress, as thousands of businesses do every day. Many of those businesses rely on government contracts or benefit, as national banks do, from federal charters.

I believe it would be a serious mistake to do anything to chill freedom of expression on this or any legislation. As you say in your letter, we may have to "agree to disagree" on some issues, but I would not be fulfilling my duties as chairman if I did not express my disagreements as cogently and forcefully as I could. Lobbying efforts are a part of the legislative process clearly protected by the First Amendment.

I hope that this response addresses your concerns. I want to reiterate my belief that these oversight hearings are appropriate, and I look forward to a continued dialogue on how we can together expand homeownership opportunities and affordable rental housing for all Americans. I have called your office to arrange a meeting, and I hope we can discuss these issues in person soon.

Very truly yours,

Attachments

International Data Management, Inc.

Database Management Specialists

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WWW.IDMI.COM

WHERE
INFORMATION
AND
INTEGRITY
MERGE

Tim Carpenter
Fannie Mae
3900 Wisconsin Ave., N.W.
Washington, DC 20016

May 31, 2000

Dear Tim:

This letter is following up our conversation on 05/22/2000, regarding the disclosure of the contract between FannieMae and IDMI to a third party. It is IDMI's policy not to make such information public for the following reasons.

First, the pricing and practices of IDMI and our vendors are proprietary. Therefore, we would not be comfortable with this information being in the public domain. This would place us at a business disadvantage when competing for additional business.

Secondly, by disclosing our contract, we would be in mutual breach of our Confidentiality Agreement. This not only affects our working relationship, but this endangers the confidentiality of IDMI's other clients as well. Many of the cost and business practices apply to them as well; therefore we would also be breaching our Confidentiality Agreements with them.

Tim, I realize the importance of the request that has been made for our contract. In lieu of supplying this, I would be willing to perform or supply a briefing of how the TM project worked. This briefing should provide all concerned parties with a high comfort level on the process, and that FannieMae and all vendors provided every safe guard to ensure the quality of this program.

I will follow up with you shortly, in the mean time please don't hesitate to contact me should you have any additional questions.

Personal regards,

INTERNATIONAL DATA MGT., INC.

Paul

Paul A. Noonan
President & CEO

International Data Management, Inc.

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Arne Christenson
Fannie Mae Corporation
3900 Wisconsin Ave., N.W.
Washington, DC 20016

June 12, 2000

Dear Arne:

Following up our conversation from this morning, I can confirm that IDMI has only performed services for Fannie Mae Corporation, and not the Fannie Mae Foundation.

We do not currently have, nor have we ever had a contract(s), or received monies from the Fannie Mae Foundation. The services that IDMI has been requested to perform, have been done strictly through and for the Fannie Mae Corporation.

Additionally, I would like to emphasize that the staff who made the outgoing calls at no time either were told to refer to the Fannie Mae Foundation or made reference to the Fannie Mae Foundation. The callers were clearly instructed by Fannie Mae to refer only to Fannie Mae, the company, and the quality control procedures that we followed affirmed that the callers adhered to these instructions.

Please don't hesitate to contact me should you have any additional questions.

Personal regards,

INTERNATIONAL DATA MGT., INC.

Paul A. Noonan
President & CEO

cc: Tim Carpenter

House Odds

Critics say Home Loan Banks' mortgage program puts system at risk

BY JIM McTAGUE • Extra! Extra! Read all about it: David terrifies Goliath — and his hefty sisters! In this headline, David is the 68-year-old Federal Home Loan Bank System, a collection of 12 independent institutions created by Congress in the Depression to fund 30-year residential mortgages made by savings and loans. Congress has since expanded the FHLBs' mission and armed them with more than a slingshot, which explains why the system finds itself locked in battle with government-sponsored mortgage giants Freddie Mac, Fannie Mae and Ginnie Mae for a share of their residential-mortgage business.

All of these entities buy mortgage loans from originators like banks, life insurers and mortgage companies, which in turn use the proceeds to make even more loans. The Home Loan Banks have a new program, dubbed Mortgage Partnership Finance, or MPF, which enables them to offer lenders a far better price for the loans than almost anyone else. The Home Loan Banks have exploited every tax, funding and capital advantage they possess by virtue of their Congressional charter to undercut the competition.

The fray is just beginning. But Ginnie Mae — the nickname for a federal agency called the Government National Mortgage Association — already has been winged. Her purchases of loans insured by the Federal Housing Administration declined significantly last month, in part because some of the biggest lenders are falling over one another to sell mortgages to Home Loan Banks. Prices of some Ginnie Mae securities, backed by pools of such loans, shot up as investors anticipated a possible shortage. It's too soon to predict whether a shortage will indeed develop.

Only eight of the 12 Home Loan Banks currently participate in the MPF program, which is licensed by the Federal Home Loan Bank of Chicago. Collectively, they have bought a mere $8 billion in loans under MPF this year; by contrast, Fannie Mae, Freddie Mac and Ginnie Mae buy several hundred billion dollars' worth apiece each year. But the Home Loan Banks' MPF purchases have been kept in check by a cap — which *Barron's* has been told will be lifted this month. When the cap is gone, MPF purchases should soar, reaching an estimated $30 billion by the end of next year, based on nonbinding commitments from lenders.

Chairman Bruce Morrison of the Federal Housing Finance Board, which oversees the FHLBs, predicts that MPF volume will hit $100 billion in two years. Lifting the cap on MPF will be his last official act before Morrison quits June 30 to become a lobbyist.

If MPF purchases continue to grow at that astronomical rate, the FHLBs could themselves become mortgage-market giants in less than a decade. Critics argue, however, that the program could crash and burn before then, leaving taxpayers holding the bag.

The party line is that benefits accruing to the bottom lines of lenders like Norwest, Wells Fargo, Chase Manhattan and Countrywide Credit Industries eventually will trickle down to the borrowers. There's scant evidence of this so far. There also are questions about whether the Home Loan Banks, which critics argue are undercapitalized, can manage interest-rate risk skillfully enough as the program mushrooms to avoid the prospect of a huge taxpayer bailout. Their regulators and presidents contend they can.

Congress thus far is treating the FHLBs much the same way they treat the Internet. It has taken a hands-off approach to let the fledgling program test its wings. In the meantime, Republican Richard Baker of Lousiana, chairman of the House Banking Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises, is holding hearings on a proposal to give the regulators of Fannie Mae and Freddie Mac jurisdiction over the FHLBs, as well, to level the playing field. If the change were enacted, the banks would need to reduce their leverage. There is no companion bill in the Senate, so there's little likelihood of such legislation anytime soon.

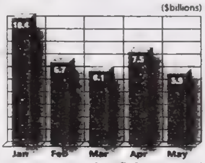
Fannie and Freddie, both shareholder-owned corporations, haven't been seriously affected yet because the MFP isn't as appetizing to originators with conventional loans to sell. But the Home Loan Banks are working on improvements, because Morrison wants FHA loans to constitute no more than a third of their purchases. The whole idea is for the banks to compete with all the secondary market players.

Freddie and Fannie have responded — not with price cuts, but with appeals to members of Congress, complaining behind closed doors that the contest isn't fair because the FHLBs are so highly leveraged. A Home Loan Bank can make do with a 7% return because of its capital structure, whereas Fannie Mae and Freddie Mac need something in the 12%-15% range. They've also been attempting to convince House Banking Chairmen Jim Leach and others that the persons responsible for MPF don't really understand the mortgage business.

According to our sources on Capitol Hill, Fannie Mae's chairman and chief executive, Frank Raines, paid a personal visit to Leach earlier this month to complain that the Home Loan Banks were paying far too much for FHA loans. The implication is that if the banks had to sell the loans tomorrow to raise cash, they'd take a big hit.

No May Queen

▶May's decline in Ginnie Mae production may be due to competition from the Federal Home Loan Banks and Fannie Mae, which have been buying up FHA loans being originated by banks and mortgage companies. Ginnie Mae buys FHA loans to collateralize its securities.



Source: The Government National Mortgage Association and industry statistics

The banks are offering lenders prices they can't possibly refuse. Commercial banks, savings-and-loans, insurance companies and mortgage companies are applying for FHLB membership in droves to take advantage of the new product. Countrywide moved a mortgage operation from Vermont to the Midwest just so it could join the Federal Home Loan Bank of Chicago, which originated the program.

A new member must buy stock in the bank in proportion to the amount it is borrowing from it. That stock is redeemable when the member decides to quit. Critics argue the stock constitutes a deposit, not capital with permanency.

Previously, an originator had two options when it made a mortgage loan: It could hold it in portfolio, an expensive undertaking given the reserve requirements and costs for hedging against interest-rate risks; or it could sell it as part of a pool of loans to one of the secondary-market agencies, which charge around 20 basis points — one-fifth of a percentage point — per year of the principal balance in the mortgage pool to cover credit losses.

Alex Pollock, president of the Federal Home Loan Bank of Chicago, felt the credit-loss fees charged by Freddie Mac and Fannie Mae were extreme, especially for lenders who are careful with their underwriting. So he devised a third option: If a lender sells a mortgage with private or government mortgage insurance covering at last 20% of the principal, his bank will share responsibility with the lender for the uninsured portion of the loan. The Chicago bank absorbs a first layer of any loss in excess of the insurance, the lender absorbs a second layer and the Chicago bank absorbs the remainder, if it comes to that. The Chicago bank pays the lender a credit-enhancement fee every month a loan goes without a default. This encourages lenders to send the FHLBs their best credits.

There are additional benefits. The loan is never on the balance sheet of the lender, which means that all of the interest-rate and prepayment risk belongs to the FHLB. The lender handles the servicing and collects servicing fees. And the lender is required to hold only a fraction of the loan's value as capital, which frees up cash for more lending.

Mortgage-market worrywarts with whom we spoke — these were not Fannie Mae and Freddie Mac employees — believe some of the banks are skimping on interest-rate hedges on MPF loans to fatten their bottom lines. Each bank decides how much risk it wants to take. Critics say the banks are leaving two-thirds of the loans "naked" (unhedged) on the assumption that they will all be paid off in five to 10 years. Such prepayments are common, owing to the propensity of homeowners to move or refinance.

Another problem, say these worriers, lies in the banks' reporting: They don't mark their portfolios to market, because if a bank's loan portfolio pulls the institution under water, lenders might hear about it and pull out, with their stock, leaving Uncle Sam to clean up the mess. The banks respond, however, that the complaints are farfetched.

"You know why they won't tell you this on the record? Because it's stupid," says Pollock.

Perhaps. But there's apparently enough concern that the system's own regulator has proposed tougher, risk-based capital standards for the Home Loan Banks. Memories of the collapse of the federally insured thrift system are apparently still fresh in Washington. ■

Fannie Mae Acquisitions
Single Family Business Only

LAWRENCE, MA-NH MSA

	TOTAL			AFFORDABLE				UNDERSERVED			
	LOANS	UNITS	UPB (000)	LOANS	UNITS	UPB (000)	%	LOANS	UNITS	UPB (000)	%
1995	2,162	2,363	230,321	848	1,004	62,565	43.50%	293	427	19,015	18.34%
1996	3,249	3,464	349,235	1,280	1,451	100,482	43.27%	414	547	30,714	15.90%
1997	2,584	2,761	295,348	976	1,112	82,390	43.18%	301	397	23,390	14.59%
1998	6,165	6,679	774,964	2,217	2,568	209,164	38.98%	755	1,039	64,015	15.75%
1999	6,171	6,684	841,450	2,174	2,553	225,517	39.01%	603	812	55,356	12.38%
YTD April 2000	955	1,043	128,917	403	464	40,717	44.92%	134	176	12,872	17.00%
TOTAL	21,286	23,014	2,620,235	7,898	9,152	720,835	40.86%	2,500	3,398	205,362	14.98%
April 30, 2000 Book Outstanding	23,885	26,094	2,533,307								

LAWRENCE, MA Central City

	TOTAL			AFFORDABLE				UNDERSERVED			
	LOANS	UNITS	UPB (000)	LOANS	UNITS	UPB (000)	%	LOANS	UNITS	UPB (000)	%
1995	142	235	7,415	98	166	4,812	71.55%	107	194	4,813	83.62%
1996	142	214	8,109	104	161	5,359	81.31%	100	168	5,143	81.16%
1997	111	170	7,367	86	136	5,288	85.27%	84	140	5,181	83.28%
1998	339	543	24,770	216	346	15,326	64.31%	240	412	17,187	76.60%
1999	265	433	23,623	179	309	15,195	75.64%	187	334	16,226	81.77%
YTD April 2000	57	85	4,794	38	58	3,001	68.24%	44	69	3,367	81.18%
TOTAL	1,066	1,680	76,078	721	1,176	48,981	72.55%	762	1,317	51,917	80.38%
April 30, 2000 Book Outstanding	1,262	1,948	85,884								

Testimony of
Thomas A. Schatz
President
Citizens Against Government Waste
Before the House Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises
June 15, 2000

Mr. Chairman, members of the committee, thank you for the opportunity to testify today. In particular, I would like to thank Mr. Baker for convening this important series of public hearings to address the issue of government-sponsored enterprises (GSEs). My name is Tom Schatz. I am the president of Citizens Against Government Waste (CAGW), a nonpartisan, nonprofit organization with more than one million members and supporters nationwide dedicated to eliminating waste, fraud and abuse in government.

CAGW is part of the Homeowners Education Coalition (HomeEC) a coalition comprised of taxpayer groups, several of which have representatives at this table today. This newly formed group intends to raise questions with our members, the media and the public about the nation's largest GSEs and how their activities impact taxpayers.

CAGW was created 16 years ago after Peter Grace presented to President Ronald Reagan 2,478 findings and recommendations of the Grace Commission (formally known as the President's Private Sector Survey on Cost Control). These recommendations provided a blueprint for a more efficient, effective and smaller government.

Since 1984, the implementation of Grace Commission recommendations has helped save taxpayers more than $625.4 billion. CAGW has been working tirelessly to carry out the Grace Commission's mission to eliminate government waste.

In fact, CAGW's interest in the activities of the nation's housing government-sponsored enterprises originates with the Grace Commission's Report on Board/Commissions - Banking.

The Grace Commission recognized the special advantages that Fannie Mae and Freddie Mac had and described the leverage these benefits conferred. The commission understood then, as do many of you of you today, that the

GSEs' "agency" status assures them access to credit at a preferential rate. The commission concluded that the implication of federal support ensured that "even without full faith and credit, the government would rescue an agency in trouble. This appears to be important in increasing the credit limits of an agency, even though less creditworthy agencies pay interest rates above more creditworthy agencies."

The Grace Commission also stated that the special advantages enjoyed by Fannie Mae and Freddie Mac distort the market. They acted as "a powerful disincentive for well-capitalized private sector entities to compete in the mortgage market." The commission also stated that there was no reason for Fannie Mae and Freddie Mac not to pay state and local taxes, and outlined a potential transition to fully private status for all government sponsored enterprises, "without threatening their ability to perform their historic mission."

The Grace Commission further noted that the concern over federal debt had not been carried over to comparable increases in agency debt. That lack of concern was related to the fact that farming and home building, two "powerful constituencies," were primary beneficiaries of the GSEs, "making them a difficult target for any activity that gives the appearance of a reduction in Government support."

The Grace Commission summed up why it is important for Congress to convene hearings such as these and to continue oversight of the GSEs. "The Government does not control agency growth because it is private; but the agencies depend upon Federal sponsorship (i.e., being treated as part of the Government) for their growth. This contradiction has extremely important consequences, now and for the future." Remember that this was in 1984.

I have included these recommendations for the record with my testimony.

Originally created to create liquidity in the secondary market for mortgages, Fannie Mae and Freddie Mac were chartered by the federal government and charged with a specific mission; to promote homeownership. In order to accomplish this mission, Fannie Mae and Freddie Mac were endowed with a raft of special privileges. For example,

- Fannie Mae and Freddie Mac do not have to register their securities with the Securities and Exchange Commission (SEC). This frees them from expensive regulatory burdens that their private-sector competitors carry. According to Treasury Undersecretary Gary Gensler, this exemption was worth $280 million to Fannie Mae and Freddie Mac last year.

- Fannie Mae and Freddie Mac are also exempt from paying state and local income taxes, an advantage that any business, small or large, would love to have. In 1999, that exemption saved Fannie Mae and Freddie Mac $690 million.

- In 1996, the Congressional Budget Office (CBO) estimated their total subsidies to be $6.5 billion in 1995. That study determined that one-third of the subsidy was absorbed by Fannie and Freddie, rather than benefiting homeowners and also appropriately questioned whether the GSEs continue to be necessary to the financial markets at all.

- Fannie and Freddie do not have to meet the same capital requirements that are imposed on banks and thrifts. In other words, they do not have to keep as much money on hand to cover losses if people default on the mortgages Fannie Mae and Freddie Mac have bought.

- Because of their special advantages, the GSEs are able to borrow at rates almost as low as the Treasury itself. Cheaper money for Fannie Mae and Freddie Mac means that they can loan money more cheaply or make more money on the same loans than their private-sector counterparts. That message has been received loud and clear on Wall Street. A May 12, 2000 Moody's press release ascribed the GSEs' high bond rating to their "good financial fundamentals, the strong implied government support of the enterprises, *and the competitive advantages they enjoy as a result of their special status*" [italics added].

- The prize that tops them all, though, is the financial markets' belief that Fannie Mae and Freddie Mac are too big to fail. This implied federal guarantee is the most significant benefit the GSEs enjoy. The CBO found in 1996 that about 40 percent of the earnings of Fannie Mae and Freddie Mac could be traced to their government-sponsored status. This implied guarantee is reinforced by the fact that Fannie Mae and Freddie Mac each have a $2.25 billion line of credit at the U.S. Treasury Department. Though they have never tapped that credit line, it is the GSEs' most visible tie to the federal government.

Since the creation of the GSEs, times have changed. Today, the nation's home ownership rates hover near 67 percent. Fannie and Freddie have played a key role in helping millions of Americans achieve the quintessential American dream of owning their own home. This kind of success is laudable. The overall economy is strong. Indeed, Fannie Mae, which was in dire financial straits just seventeen years ago, is now on sound financial footing and both Fannie Mae and Freddie Mac today enjoy double digit growth rates.

In addition, because of the outstanding success of the securitizations undertaken by Fannie Mae and Freddie Mac, the notion of securitization is a firmly established financial practice. Today, thousands of private entities are standing by with sophisticated techniques to securitize everything from credit cards to taxi cab licenses in New York City, thanks in large part to the successful example established in the marketplace by the GSEs.

If that were the end of the story, we wouldn't be here today. The activities of Fannie Mae and Freddie Mac do not exist in a vacuum. Their duty to shareholders requires that they maximize profits. Yet, since there is also a duty to the taxpayers that runs with their special status, one mission necessarily comes into conflict with the other. There are strong indications that the GSEs' activities in recent years have begun to stray from their chartered mission, that their primary motivation has become the pursuit of high profit, and that this is driving them into increasingly risky financial practices.

If Fannie Mae and Freddie Mac were purely private, and if they were not supported by tens of billions of dollars worth of taxpayer-backed special benefits over the years, the nature of their activities might attract only a passing glance. But Fannie Mae and Freddie Mac are not purely private. In fact, their lucrative links to the federal government obligate Congress and the industry's regulators to pay special attention to what they do and how they do it. Failing to exercise an appropriate level of oversight would be an abrogation of Congress' constitutional duties.

Questions raised about Fannie Mae and Freddie Mac must not be characterized as dry academic musings or dismissed as the rantings of disgruntled competitors, as several Fannie Mae and Freddie Mac representatives have repeatedly tried to do. Fannie Mae and Freddie Mac have characterized those who have made an issue of their activities as being "anti-homeownership." As an individual taxpayer group with a 16-year track record of exposing waste and mismanagement and as a member of the HomeEC coalition, we are one of those falsely accused of wanting to drive up costs for homeowners. Nothing could be further from the truth. Unfortunately, it is not unusual for CAGW and others who wish to maximize the efficient use of tax dollars to be attacked by federal agencies and others who are loath to submit to the scrutiny of congressional oversight or suggested improvements in their operations.

CAGW is proud of our desire to increase oversight of Fannie Mae and Freddie Mac. In fact, the U.S. Treasury Department shares our concerns. The U.S. General Accounting Office shares our concerns. The Congressional Budget Office shares our concerns. As of May 19th, we can count Alan Greenspan,

Chairman of the Board of the Federal Reserve System, among our allies. The truth is that the housing GSEs have become so ascendant in the financial markets that their activities have far-reaching effects throughout the entire national financial system and therefore into the pocketbooks of ordinary citizens.

How large are they? By 2003, Fannie Mae and Freddie Mac combined will have more debt outstanding than Treasury debt held by the public. It is ironic that Fannie Mae Chairman Franklin Raines, as former director of the Office of Management and Budget, saw the national debt begin to ebb during his tenure there, only to preside over an explosion of implicitly taxpayer-backed debt at his next job.

In January of this year, Fannie Mae announced that it was positioned to issue its debt securities in unlimited quantities, a statement that ought to send chills down the spine of taxpayers. At current growth rates, by the year 2005, the GSEs are expected to carry $3 trillion in debt.

This is a point that has been addressed by Treasury Undersecretary Gary Gensler in his March 25th, 2000 testimony before this subcommittee. Mr. Gensler characterized the $1.4 trillion in current GSE debt as "large on any relative scale. It is now roughly the size of the entire municipal bond market," which is the combined debt of all fifty states and localities that issue publicly traded debt. That figure does not include the $1.2 trillion in GSE-guaranteed mortgage backed securities.

From the time of their congressional charters in the late 60's and early 70's Fannie Mae and Freddie Mac have grown exponentially, well beyond the imagination of anyone active in those decisions. According to the Treasury Department, last year Fannie and Freddie together either owned or guaranteed 63 percent of the outstanding conventional mortgages in the country. GSEs are no longer passive pass-through agencies in the secondary mortgage market. As Mr. Gensler pointed out, the GSEs' willingness to purchase a mortgage on the secondary market now more or less dictates whether the mortgage will be written at all.

It isn't just the amount of their debt which ought to trouble taxpayers. After all, the congressionally chartered purpose of the GSEs is to provide liquidity in the mortgage market, to purchase mortgages, bundle them into securities and resell them to private sector investors, who then bear the risk. Today, what Congress, regulators, and taxpayers ought to be focused on, in addition to the amount of the debt they have outstanding, is the nature of the debt they hold in their own portfolios, the maturity of the mortgage market, and the direction Fannie Mae and Freddie Mac are taking in the future. In particular,

the proposed replacement of Treasury debt with Fannie and Freddie debt as a marketplace benchmark deserves the utmost scrutiny. That is a major concern expressed by Chairman Greenspan in his recent letter.

Since 1993, Fannie and Freddie have begun to repurchase their own mortgage-backed securities and hold them in portfolio. Why? The answer is profit. Fannie Mae and Freddie Mac have experienced double digit growth rates over the last few years. Their institutional investors and stockholders have become very accustomed to those high profits and Fannie Mae and Freddie Mac have committed publicly to continue to deliver those kinds of profits on an annual basis. Repurchasing mortgage-backed securities is one way to scoop up higher profits. This is why, in our view, the percentage of mortgage-backed securities held on Fannie Mae's books has increased from 5 percent in 1993 to 29 percent in 1999. Instead of dispersing risk into the private market, where it belongs, Fannie and Freddie are reconcentrating it in their own portfolios, which are implicitly backed up by the taxpayers. The question that Congress should be asking is "how does repurchasing mortgage-backed securities further the congressionally-chartered missions of Freddie Mac and Fannie Mae?" This question has not been adequately answered.

The Grace Commission recognized that GSE debt would expand and suggested that such expansion be restrained by proposing, in recommendation BANK 40-2, that "Congress should be requested to mandate that organizations having agency status be allowed to invest only in Government securities unless held pursuant to their mission. This will remove the opportunity for an agency to arbitrage investments against its lower cost of borrowing." This is precisely what Fannie Mae is now doing.

Groups such as CAGW and the other organizations in HomeEC represented at this hearing today are pressing for oversight on behalf of taxpayers because our members vividly remember the S & L crisis of the 1980s and the $500 billion bailout of the 90s, which they paid for. We applaud Chairman Baker for stimulating a much-needed debate about the government-sponsored enterprises, their activities, their motivations, and their impact on average taxpayers. It is timely and we urge you to continue pushing for disclosure, transparency and clarity with regard to the GSEs.

With regard to the specifics of H.R. 3703, CAGW commends Chairman Baker, Chairman Jim Leach and their colleagues for co-sponsoring the bill. The legislation has obviously ruffled a few feathers and brought down a firestorm of criticism from some quarters. All we can say is, our one million members and supporters thank you for simply doing what more subcommittees should do –

make sure that programs and policies continue to be effective, and modify or terminate them if they don't.

CAGW views several aspects of this legislation as extremely well-advised. In particular, we strongly favor the elimination of the GSEs' lines of credit with the U.S. Treasury. These credit lines are miniscule in comparison to the GSEs' potential liabilities and their existence sends a false message to Wall Street that taxpayers would bail the GSEs out in a financial crisis.

We also believe that Congress must examine the GSEs' forays outside their charters into highly competitive financial areas where they unfairly undercut competition.

And we concur with Treasury Undersecretary Gary Gensler's concerns as to whether commercial banks ought to be permitted to hold in portfolio unlimited percentages of GSE debt. This practice also reinforces the notion that the debt of the GSEs is equivalent to the debt issued and explicitly guaranteed by the Treasury, and reinforces the belief that the GSEs are too big to fail and that taxpayers will be forced to shore them up in an emergency. This is an issue that should be explored further by the subcommittee.

During his recent testimony before this subcommittee, Fannie Mae's Chairman repeated several times that Fannie Mae's activities pose "zero risk" to the government and to taxpayers. This statement is very misleading. In the world of high finance, growth and a high rate of return are inextricably linked to risk. There is much to talk with regard to risk management, but I'd like to take a moment to address one issue that has recently made the papers.

I refer to the ads that Fannie Mae has been running in which they talk about the financial "stress test" they are required to undergo. This stress test was established as part of 1992 legislation, which also created the GSEs' regulator, the Office of Federal Housing Enterprise Oversight. Mr. Raines also referred to the stress test in his testimony before this subcommittee.

Now would be a good time to set the record straight on the stress test. This regulation, which is designed to certify the financial safety and soundness of the GSEs, has not in fact gone into effect, though it is in its final stages. Even so, almost nine years after the law requiring this test was enacted by the Congress, it will be at least another year before it is activated. What is more, Fannie Mae in particular has consistently resisted submitting to the stress test. It is strange indeed to now see Fannie Mae extolling the virtues of a regulation that they have consistently argued against and which has never actually been applied.

Mr. Chairman, CAGW would like to submit the ad, along with a series of letters from Fannie Mae criticizing the stress test, into the record.

With Fannie Mae and Freddie Mac, we have two mammoth quasi-governmental entities that claim agency status when it suits them and simultaneously claim to be private financial institutions when it suits them.

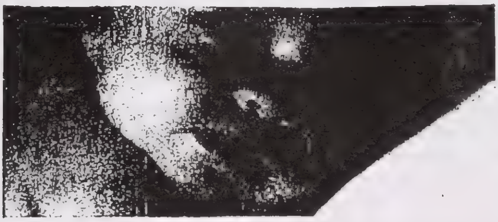
Franklin Raines has stated that the great success of Freddie Mac and Fannie Mae shows that one can pursue a public mission and still deliver high returns to shareholders. But the usual experience is quite the opposite. This kind of public/private schizophrenia breeds mismanagement and inefficiency and often ends up costing taxpayers billions. As one longtime observer of the financial markets has noted, with the creation of Fannie Mae and Freddie Mac, we have only succeeded in privatizing the profits, while socializing the risks.

Taxpayers must not be victimized again by a financial crisis that would dwarf the S & L crisis. Now, while the economy is strong, is the best time to begin examining crucial questions regarding the nature of the nation's government-sponsored enterprises.

On behalf of our one million members and supporters, we thank the committee for the opportunity to speak to you today and are available to answer any questions you might have.

THE WALL STREET JOURNAL

MONDAY, JUNE 5, 2000



With millions of American families counting on us, we have to be built to withstand anything the economy throws at us.

Eight years ago, Congress passed legislation meant to ensure that Fannie Mae, a privately managed, shareholder-owned company, would always be run in a safe manner. You see, as the largest source of funds for home mortgages and a company with hundreds of billions of dollars in assets, it's critical that the financial markets, policymakers, and American home buyers know that Fannie Mae will always be financially sound.

Today, our service to the American home buyer has never been more important. We lower mortgage costs while helping to ensure there is never a shortage of mortgage funds. And even as we've become larger, we've also become financially stronger. Because of the farsightedness of Congress, Fannie Mae's capital standard is the toughest in the financial services industry. It begins with the fact that we can only invest in one type of asset. Unlike banks, which use taxpayer-insured deposits to finance everything from credit card loans to loans to foreign countries, Fannie Mae invests in one of the world's safest assets: mortgages that finance homes in America.

To finance the mortgages we own or guarantee, Fannie Mae has to hold enough capital to withstand interest rates either rising or falling by up to six percentage points and staying there for ten years. Simultaneously, we have to be able to sustain catastrophic credit losses equal to the worst regional experience in the last 20 years — such as what happened to a portion of the oil patch states in the late 1980s. Wait — there's more.

We also have to hold an *additional* 30 percent in *extra* capital to cover management and operations. That's right: interest rates soaring or plummeting, the entire economy collapsing, and an extra 30 percent in capital held to boot.

No other class of financial institutions has such a tough standard. And very, very few others could meet it if they did.

Fannie Mae. Putting private capital to work. Lowering costs. Lowering risks.

FannieMae

FannieMae

James A. Gorelick
Vice Chair

3900 Wisconsin Avenue, NW
Washington, DC 20016-2892
202 752 6120
202 752 5980 (fax)

October 27, 1998

BY HAND
Mr. Mark A. Kinsey
Acting Director
Office of Federal Housing Enterprise Oversight
1700 G Street, N.W.
Washington, DC 20552

Dear Mark:

I am writing to express my strong objection to your intention to include with OFHEO's risk-based capital notice of proposed rulemaking ("NPR 2") that will be submitted to OMB this week a calculated dollar or percentage amount of capital required to be held by Fannie Mae and Freddie Mac under the test.

Release of the theoretical results of a proposed stress test serves no public policy purpose. The final risk-based capital requirement for Fannie Mae and Freddie Mac will be determined after a long comment period on NPR 2, during which time OFHEO's model could change in many dimensions, be substantially redrafted or withdrawn. The 1992 statute does not require OFHEO to publicly attach a numerical capital requirement in the proposed rule stage and, to the contrary, does not contemplate such action. Section 1361(a) of the statute says: "when applied to an enterprise, the risk-based capital test shall determine the amount of total capital for the enterprise...."(emphasis added). This statement clearly implies that the regulation should include the "test" and not the result. Moreover, it is difficult to see how a capital test in the NPR stage could be "applied" within the meaning of a statute that contemplates that the test will determine the final amount of capital an enterprise is required to hold.

As you know, we are currently very well capitalized. Your office has so determined under the present regulatory structure, and this determination was confirmed last year by the AA- "risk-to-the-government" rating conferred upon us by Standard and Poor's in an exercise your office initiated. We are confident that we will be able to meet any reasonable stress test. As you have said, there will be a number of avenues open to us to alter our risk profile to achieve full compliance with the final regulation once it becomes effective. We know that, you know that, but the general public does not.

We are very concerned that, should you include a calculated capital "shortfall" in the regulation you submit to OMB, this number may be shared with others who will not have a proper context

within which to evaluate it. because few if any will understand the assumptions and methodology underlying your model.

In today's highly volatile financial environment. the capital adequacy of financial institutions is being accorded tremendous weight. In our view. there is nothing to be gained. and potentially much to lose. should a calculated capital shortfall be taken out of context and construed by a nervous public to mean that we are anything other than the rock-solid anchor of the mortgage finance system that we are.

One does not have to wander very far from today's headlines to see what concerns about a financial institution's financial health can do. The commercial mortgage-backed security market, the home equity market, the high-yield bond market and the subprime mortgage market all are effectively closed down today because of investor concerns about the health of the institutions that underpin them. The conforming residential mortgage market alone has escaped this turmoil. thanks almost entirely to the presence and effectiveness of Fannie Mae and Freddie Mac.

The purpose of OFHEO is to promote the safety and soundness of Fannie Mae and Freddie Mac. It would be unconscionable for OFHEO to actually create a perception of capital inadequacy where none occurs in fact. based on the misinterpretation of a number that OFHEO need not transmit in the first place.

I strongly urge you to reconsider this critical matter. and would like to discuss it further with you at your earliest convenience.

Sincerely,

Jamie S. Gorelick
Vice Chair

cc: Anne E. Dewey
Donald R. Arbuckle

FannieMae

Jamie S. Gorelick
Vice Chair

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December 4, 1998

BY HAND

Mr. Joshua Gotbaum
Executive Associate Director
Office of Management and Budget
Washington, D.C. 20503

Mr. Donald R. Arbuckle
Deputy Administrator, Office of
Information and Regulatory Affairs
Office of Management and Budget
Washington, D.C. 20503

Dear Messrs. Gotbaum and Arbuckle:

Thank you for taking the time to meet with us about OFHEO's second notice of proposed rulemaking ("NPR 2") on risk-based capital standards for Fannie Mae and Freddie Mac, now under consideration by OMB. Although Fannie Mae has not had a chance to review NPR 2, I think we all can agree that developing reasonable, appropriate risk-based capital standards is extremely important to the Administration's housing policy.

Fannie Mae plays a central role in the U.S. housing markets through our public mandates to provide liquidity and stability to the housing market and to promote affordable housing. I have enclosed, as I promised, a chart showing the importance of the liquidity function performed by Fannie Mae, especially over the last few months, as well as selected news articles regarding Fannie Mae's role during the recent liquidity crisis. We remain available to discuss the effect on both our ability to provide liquidity and our affordable housing mission of different approaches to risk-based capital.

As I noted at our meeting, we are concerned that OFHEO has not given Fannie Mae any opportunity to engage in a dialogue about the substance of this very complex and technical undertaking. We strongly believe that we are appropriately capitalized and that our risk-based capital models produce accurate assessments of the capital we need. We have a stronger credit rating than any thrift and all but a few banks. We doubt that the regulators of those institutions, which have government guaranteed deposits, would say that the industries the

undercapitalized. Therefore, if OFHEO's proposed model suggests the need for additional capital, serious questions should be raised about the model and its assumptions.

I have enclosed the paper I promised which outlines a less intrusive alternative, which makes use of the expertise of Fannie Mae and Freddie Mac while assuring more than adequate supervision through regulatory examination.

As we discussed, there are critical policy choices embedded in the OFHEO proposal – choices that may well determine whether there will be sufficient funding for housing in this country and sufficient affordable housing in our cities and underserved areas. For this reason, I have taken the liberty of submitting to you a set of questions OMB might ask as it considers the model OFHEO proposes in NPR 2.

We understand that this letter and the attached materials will become a matter of public record.

Once again, thank you for your consideration and please let me know if I can be of any assistance to you and your staff.

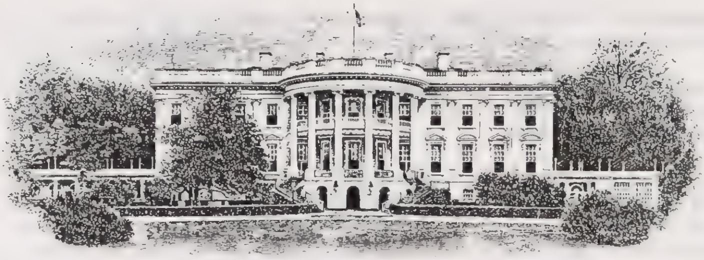
Sincerely,

Jamie S. Gorelick

Jamie S. Gorelick

Attachments

cc: Mark Kinsey



PRESIDENT'S PRIVATE SECTOR SURVEY ON COST CONTROL

REPORT ON
BOARDS/COMMISSIONS - BANKING

APPROVED BY THE SUBCOMMITTEE FOR THE
FULL EXECUTIVE COMMITTEE, SPRING-FALL 1983

II. ISSUE AND RECOMMENDATION SUMMARIES (CONT'D)

G. FEDERAL NATIONAL MORTGAGE ASSOCIATION AND FEDERAL HOME LOAN MORTGAGE CORPORATION

BANK 34: TAXATION OF THE FEDERAL HOME LOAN MORTGAGE CORPORATION

Issue and Savings

Can the present Federal tax exemption for the Federal Home Loan Mortgage Corporation (FHLMC) be removed?

Based on December 31, 1981, financial statements, an estimated $16.4 million in Federal taxes would have been owed. Over three years, additional revenue of $54.2 million would be available.

Background

This issue most recently arose during consideration of H.R. 4787 and H.R. 6442, which would have reorganized and recapitalized FHLMC. When FHLMC was established in 1970 by P.L. 91-351, it was granted exemption from Federal, state, and local taxation (12 U.S.C. 1452(a)), except for property tax. When the Federal National Mortgage Association (FNMA) was transferred to private ownership in 1968, it lost its Federal tax exemption -- but not its local and state exemptions -- and its obligations became generally subject to taxation. Accordingly, the bills to reorganize FHLMC proposed comparable tax status for the corporation and its obligations.

The proposal for taxation in H.R. 4787 called for Federal taxation only after a dividend was paid on common stock (other than that outstanding stock previously issued to members of the Federal Home Loan (FHL) banks). No provision in the bill required issuance of common stock: the amount and frequency of dividends were left to the discretion of the Board of Directors. Dividends could, under the bill, be paid only from retained earnings.

Methodology

Background documents, legislation, and testimony were examined; interviews were held with FHLMC officials, investment banks, Office of Management and Budget (OMB) officials and others; a tax advisor reviewed options.

Findings

The Task Force decided to recommend taxation of FHLMC because of its strong financial position and its likelihood of continued growth. There is no evidence that taxation would impair FHLMC's mission. Last year FHLMC reduced its rate of provision for uninsured principal losses, increasing income for 1981 by $8.4 million. This indicates either an ample build-up of capital or a decreased expectation of loan loss; in any case, the future seems bright for FHLMC.

Assuming that FHLMC's existing provisions for losses are valid tax deductions, the net income tax owed on its net 1981 income of $30.9 million (after a $16.4 million addition to reserve for uninsured principal losses) would be $14.2 million.

Conclusions

Effectively, FHLMC acts as a mortgage company and should be taxed as one. If any special reserves should accumulate on a tax-free basis because of FHLMC's Congressional charter and special mission, Congress could so legislate. However, FHLMC seems able to maintain and expand its service offerings without this further privilege. Indeed, its willingness to pay Federal taxes as part of its own restructuring proposal suggests strongly that FHLMC is able to pay taxes presently.

Although the Task Force did not consider it part of its mandate to recommend state and local taxation, there does not seem to be any obvious reason why FHLMC should not pay those taxes as well.

Recommendations

BANK 34-1: Congress should amend 12 U.S.C.1452 (a), the Federal Home Loan Act of 1970, to remove the FHLMC tax exemption.

Savings and Impact Analysis

Tax revenues for the Treasury would increase. There would not necessarily be any increased cost to lenders, and ultimately homebuyers, after FHLMC is taxed. We estimated the taxes paid in the first year would be $16.4 million, $18.0 million in the second, and $19.8 million in the third.

Implementation

The President should ask Congress to enact this proposed change. There is no evident reason to delay or phase-in taxation.

II. ISSUE AND RECOMMENDATION SUMMARIES (CONT'D)

G. FEDERAL NATIONAL MORTGAGE ASSOCIATION AND FEDERAL HOME LOAN MORTGAGE CORPORATION (CONT'D)

BANK 35: NEUTRALIZING AGENCY STATUS OF FNMA AND FHLMC

Issue and Savings

Can the agency status of the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC) be neutralized so that private sector market makers and investors will be willing to enter the mortgage financing market?

Taking this step could lead to an enlarged capability for residential mortgage financing which has enormous importance for a strong economy. Savings are included in Bank 40, Privatizing Federally Sponsored Agencies.

Background

FNMA came into existence in 1938 and was made private in 1968. Ten of its 15 Board members are public; the President of the United States appoints the other five. The Government maintains regulatory authority over FNMA through the Secretary of Housing and Urban Development (HUD). As a private corporation, FNMA operates for profit and its shares are traded on the New York Stock Exchange. Its most significant function is to buy mortgages at market rates from savings and loans and banks, and finance this activity by issuing debt with "agency" status. In effect, FNMA operates as a national savings and loan (S&L) that provides liquidity to the secondary mortgage market. Like other S&Ls, FNMA has been hurt by its practice of lending long term at fixed rates but financing short term. In 1981, it had $260 million of negative interest differential and an after tax loss of $191 million. Recent reductions in interest rates should improve profitability.

In 1981, FNMA expanded its scope of activities by targeting mortgages to special investor needs through its Mortgage Backed Securities (MBS) program of ensuring prompt payment of principal and interest for certificates backed by pools of conventional mortgages. It also plans to step up its selling of pass-through certificates.

FNMA declined to participate in the Task Force study, claiming private status.

FHLMC is a wholly owned subsidiary of the Federal Home Loan (FHL) Banks. Along with FNMA it provides liquidity to the FHL Banks in the secondary mortgage market. It recently tried to go private by having a privatization bill introduced on its behalf in Congress. FHLMC's sense of going private focused on issuing stock to the public. The principal motive behind this effort was to increase capital. The bill would have allowed FHLMC to be taxed, but the corporation would have retained its agency status.

FHLMC's principal product is pass-through certificates, but it also is starting to guarantee prompt payment of debt backed by conventional mortgages. Thus, FNMA and FHLMC are moving toward overlapping activities.

FHLMC has a good earnings history and a strong balance sheet. It is small, however, relative to the potential credit demands of the conventional home mortgage market. As evidence of this, FHLMC envisioned that its expansion into this market would have involved $44.3 billion of new borrowing through fiscal 1983 versus a balance sheet debt of $5.5 billion for the year ended 1981.

The Administration's objection to the legislation was that the bill did not privatize FHLMC enough, but would instead increase agency debt dramatically at a time when it was trying to curb growth in Federally related debt. Since the legislative initiative failed, FHLMC's ability to expand rests on its present capital base. The Federal Home Loan Bank Board (FHLBB) must approve expansion in the debt.

Agencies of the Government have several advantages over the private sector in the issuance of debt. Their relative values are hard to assess since interviews with dealers in the market yielded different insights. However, there was unanimity that agency status allows almost unlimited borrowing at preferential interest rates. The advantages of agency status are:

- <u>Line of credit to Government</u> -- this factor is not considered important since the dollars involved are usually small; rather, the connection to the Federal Government is the key element.

- <u>Regulatory exemptions and preferences</u> -- these are very important and include exemptions from Securities and Exchange Commission (SEC) oversight; legal investments for Federally supervised institutions; eligibility to be used as collateral at the Federal Reserve Bank window; exemption from

state and local taxes; unrestricted investment by national banks; eligibility to be used as collateral for Federal, state, and local deposits; eligiblility for investment by Federal savings and loans, mutual savings banks, and Federal credit unions.

- Marketplace -- agency paper is traded at the "agency desk" in market-maker trading rooms. This important practice allows easier placing of the paper and creates a more liquid secondary market.

- Federal support -- implication is that even without full faith and credit, the Government would rescue an agency in trouble. This appears to be important in increasing the credit limits of an agency, even though less creditworthy agencies pay interest rates above more creditworthy agencies.

Methodology

A view of the issues was formed in discussions with officials of FHLBB, FHLMC, the Adminstration, and investment bankers, as well as from reviewing selected financial data, the Report of the President's Commission on Housing, and testimony offered in the Congressional hearings on H.R. 6442 -- the FHLMC privatization bill.

Findings

Both FNMA and FHLMC want to become fully private. They would even be willing to give up the special advantages agency status offers in handling mortgage-related instruments if they could be reasonably assured of prospering in such an environment. However, for different reasons, they both fear losing agency status now. In FNMA's case, it has expertise and experience, but because of recent losses, a weakened balance sheet. FHLMC has a strong balance sheet and a record of imaginative innovation, but the size of its balance sheet is such that it feels it can survive only with agency status.

In the description of agency status, above, the advantages are summarized as an almost assured access to credit at a preferential rate. However, in converting mortgages to a form that can be bought and sold to market makers and investors, agency status has other advantages far outweighing access or rate considerations. This is stated explicitly in the Report of the President's Commission on Housing:

- Marginability -- Regulation T of the Federal Reserve Board permits credit to be extended on most corporate bonds but not on mortgage pass-through certificates.1/

- Bank participation -- National banks can pledge their assets to secure borrowing, but not a "private deposit." Because of the ambiguity as to whether a mortgage-backed bond is a borrowing or a deposit, national banks tend not to issue mortgage-backed bonds. Savings and loans do so routinely.

- Pension fund participation -- Employee Retirement Income Security Act (ERISA) regulations are interpreted to mean the pool of mortgages rather than a certificate representing the pool which constitutes "pension plan assets." Further, they require active prudent management of these assets. However, the vehicle to create a pool of mortgages -- a grantor trust -- must be a passive unmanaged vehicle for tax purposes. Consequently, regulations interpreting ERISA do not allow investments by pension funds. While relief is available in the form of administrative exemptions, this provision represents a significant practical problem.

- Tax considerations -- Profits resulting from principal repayments of mortgages are treated as regular income, whereas market premiums are deductible only as capital loss. This treatment is the opposite of corporate or Government debt.

The examples also illustrate the significance of agency status. Agency debt, including certificates evidencing a pool of mortgages and having agency status, is marginable and eligible for investment by pension funds.

The advantages enjoyed by FNMA and FHLMC of agency status in placing debt and in not being disadvantaged in the issuance of mortgage-related securities act as powerful disincentives for well-capitalized private sector entities to compete in the mortgage market. While these advantages are significant, there is also a psychological component to the private sector's reluctance to compete in that market: Why put energy and resources into a market structurally stacked against you? Target a market without that problem.

1/ Regulation T has been changed to allow purchases of mortgage pass-through certificates effective January 1983.

Conclusions

- FNMA and FHLMC should go private because their agency status inhibits private institutions from competing with them in their areas of operation, providing liquidity as a secondary market for mortgages.

- At the same time, FNMA and FHLMC do not have sufficient capital to finance this market themselves.

Until recently, overall high mortgage interest rates have held back home building and buying. The demographics strongly suggest, however, that when interest rates fall, there will be tremendous activity in residential home financing. The Task Force feels it would be tragic if the agency status of FNMA and FHLMC were to block the receipt of sufficient capital in this market. New capital and a new structure are needed to supplement the traditional sources of home purchase financing -- the savings and loans and mutual savings banks. Financing will depend more and more on national markets, institutional lenders, and a liquid, effective secondary market. The Task Force would like to use the issue of eliminating the advantage of FNMA's and FHLMC's agency status to recommend another constructive step toward creating a viable secondary market for mortgages.

If FNMA and FHLMC were to go private today, nobody could replace the functions they perform and the marketplace would suffer. There must be an effort starting now toward eliminating the regulatory, legal, and tax disincentives inhibiting non-agency entrance into the market. While this is being accomplished, FNMA and FHLMC would continue in the market with agency status, but should move toward full privatization. Both these processes will take time. In addition, for the private sector to compete, it must see progress so that it can plan for its entry. A huge new market will be created as each participant adds its own individually evolved capability.

Recommendations

BANK 35-1: The Congress should authorize that a fee on outstanding debt be charged by the Treasury for the use of agency status. This fee, calcuated in basis points, would be increased annually.

BANK 35-2: The Congress should mandate that organizations having agency status be allowed to invest only in Government securities (other than investments pursuant to their mission).

BANK 35-3: An ad hoc private sector working group should be formed to research and recommend solutions to problems of access to the mortgage market for dealers and investors.

Savings and Impact Analysis

The first three recommendations are designed to begin full privatization without jeopardizing the agencies' missions with a dramatic structural change.

Using a nominal value of 01 basis points as the reduction in interest charge to the Government for each dollar switched from a non-Government to a Government investment yields $84,000 for FNMA and $63,000 for FHLMC (not carried over to total).

The third recommendation may be one of the more important results of our work. The analogy we see is to the creation of the BASIC Committee that was active in changing laws and regulations allowing electronic book transfer of evidence of security ownership. This committee dealt with registrars, transfer agents, brokers, banks, and security-issuing companies in areas involving the Uniform Commercial Code, SEC oversight, state banking regulations, etc. Eventually, a consensus was reached, needed legislation achieved, and depositories created to perform the desired activities effectively.

It is believed a private sector working committee is the appropriate way to enlist the cooperation of the myriad interested parties. Since this committee would not be an official part of the Government, it would be initiated by a private sector effort.

The Task Force believes that the points made above have been said elsewhere by other parties but their significance has not been properly recognized. We hope that by emphasizing this point, the required initiatives will be implemented.

Implementation

The first two recommendations need enabling legislation developed and passed.

II. ISSUE AND RECOMMENDATION SUMMARIES (CONT'D)

I. FARM CREDIT ADMINISTRATION (CONT'D)

BANK 40: PRIVATIZING FEDERALLY SPONSORED AGENCIES

Issue and Savings

How can Federally sponsored private agencies (the agencies) be encouraged to go fully private without threatening their ability to perform their historic mission?

The approach recommended would enhance Government revenues $120.7 million in the first year of operation based upon September 1982 levels of debt. Revenues would continue to increase annually at approximately that amount until full privatization was accomplished.

Additionally, to the extent that future agency borrowings would be moderated, the Government would have reduced costs on its own borrowings. This saving cannot be easily approximated but, in the extreme, could reasonably be in the billion dollar range. Finally, while not a dollar savings, moderating increases in agency debt would support Federal fiscal goals.

Background

Note: BANK 40 provides further detail to support and summarize recommendations made in other issues. It is provided because the Task Force believes it is essential that all recommendations related to "privatization" be viewed as a whole, and not as an attack on any one agency or group of constituencies.

There is almost universal recognition that the high level of Federal deficits can lead either to the inhibiting of private investment (crowding out) and high interest rates if the deficits are financed from savings, or renewed inflation if the Federal Reserve monetizes the debt. Both possibilities are viewed as unacceptable and much of current Government planning revolves around attempts to avoid these alternatives. This concern has not been carried over to comparable increases in agency debt to nearly the same extent, although spokesmen for the Administration have pointed out their unhappiness about increased agency borrowings, in testimony before Congress. Reluctance to deal with the problem of a high rate of growth in agency debt come in part

from the consideration that the two principal beneficiaries are farmers and the home building industry. These groups are at the same time both powerful constituencies and troubled spots in the economy, making them a difficult target for any activity that gives the appearance of a reduction in Government support.

Methodology

Interviews were conducted within the Farm Credit Administration (FCA) which is the regulatory body for the 37 banks of the Farm Credit System (FCS), the Federal Home Loan Bank Board (FHLBB), the Federal Home Loan Mortgage Corporation (FHLMC), the General Accounting Office (GAO), the Office of Management and Budget (OMB), and investment bankers, economists, lawyers, and rating services knowledgeable in the primary or secondary market for Treasury, agency, and corporate debt. Additionally, reports of these agencies and transcripts of testimony before Congress were reviewed, principally H.R. 6442 - the FHLMC privatization bill. Officials of the Student Loan Marketing Association (SLMA) were consulted informally. The Federal National Mortgage Association (FNMA) chose not to participate in the President's Private Sector Survey (PPSS) review, claiming status as a private corporation.

Findings

As Table II-8 below illustrates, outstanding debt for the three largest Federally sponsored private agencies grew from $107.0 to $241.4 billion for the three years and nine months ending September 1982. This is a compound annual rate of increase of 24 percent. In absolute terms, it means that these agencies have absorbed $30 billion of private savings more each year for this period. Growth in outstanding debt is expected to continue in 1983 and beyond.

Table II-8

FEDERALLY SPONSORED PRIVATE AGENCIES
INTEREST BEARING SECURITIES OUTSTANDING, YEAR END 12/31
($ billions)

	1978	1978	1980	1981	September 30 1982
FCS	$ 41.2	$ 49.8	$ 61.1	$70.9	$ 74.4
FHLBB System	27.4	45.5	54.1	76.8	98.9
FNMA	38.4	46.4	52.4	56.7	68.1
Total	$107.0	$141.7	$167.6	$204.4	$241.4

Source: Treasury Bulletin attached as Exhibit II-25.

OMB pointed out in testimony before Congress that this growth threatened economic recovery in the same way as the large Federal deficit. Since this growth in outstanding debt was larger than the increase in Federal deficits for the 1978-1982 period, it is surprising that more attention was not paid to OMB's concern. OMB contended as well that the growth in agency debt was counterproductive; in the home building sector, increased agency (i.e., Government) activity discouraged potentially much greater purely private sector investment. While there was interest in the OMB point of view, it did not generate enthusiastic support. From the point of view of some in Congress, agency borrowing represented private borrowing in a private market for private purposes.

Control over agency activities is exercised by an amalgam of private and Government interests. The constituent banks of the Farm Credit System each has a board of directors elected by the members (and owners) of the bank. The banks as a group are subject to oversight by the Farm Credit Administration, the Governor of which is appointed by the Farm Credit Board. The Federal Farm Credit Board consists of a representative of the Secretary of Agriculture and 12 other members appointed by the President. Borrowings (Securities are obligations of the Farm Credit banks.) by FCS are subject to general review and approval by the Governor of FCA, who is required to consult with the Secretary of the Treasury in this regard. FCA activities are also subject to review by Congress.

The stockholders of each of the 12 Federal Home Loan (FHL) Banks are member thrift institutions of the FHLBB. Each FHL Bank is managed by a board of directors, slightly over half of whom are elected by the member stockholders and remainder of whom are appointed by the FHLBB. The three members of FHLBB are appointed by the President. FHL Banks are also subject to general oversight and annual budget approvals by FHLBB. Borrowings by the FHL Banks System are a joint and separate obligation of all FHL Banks and may be incurred only by action of the FHLBB. Such borrowings are also subject to the approval of the Secretary of the Treasury. FHLBB activities are subject to annual review by Congress.

FNMA is managed by a 15-member board of directors, five of whom are appointed by the President and ten of whom are elected by the shareholders. Shares of FNMA are traded on the New York Stock Exchange. Borrowings by FNMA are subject to approval by the Secretaries of the Treasury and of Housing and Urban Development (HUD), and FNMA is subject to the general regulatory authority of the Secretary of HUD.

While there are, therefore, bases upon which the Government can control the actions of the agencies (e.g., their level of borrowings), in practice there is little exercise

of this authority. Perhaps this is because the lines of control are so indirect. Perhaps since the agencies are viewed as at least quasi-private, direct control is considered as inappropriate in spite of any legal justification for it. In fact, Congressional oversight hearings of agencies do not focus on levels of borrowings. The view of Congress seems to be that whereas expenditures of the Government are tied directly to legislative initiative and review, agencies, even though Federally sponsored, are private and should respond to the same constraints as other private organizations. The ability to borrow should be a function of the marketplace. A private firm should optimize its debt according to its needs and ability, its costs and benefits. Congress also endorses the missions of FCS, the FHLBB and FNMA. Combined with the political difficulties attached to change, it is easy to understand the lack of enthusiasm for a new initiative. An important further consideration is that it is not clear what could or should be done, even if one were opposed to the growth in debt.

A closer examination of agency borrowing will help in evaluating its characteristics and therefore how subject agency borrowing is to the constraints of the marketplace, as the Congress believes. The salient feature for most observers is that agency debt is not backed by the full faith and credit of the U.S. Government. There are emergency lines of credit available from the Treasury, varying from agency to agency, but these are quite small relative to the debt involved. For example, FHLBB has recourse to the Treasury for $4 billion in an emergency but 1982 year-end debt exceeded $100 billion. The lack of full faith and credit backing is the strongest argument by which agency debt can be considered "private." The characteristic that points toward agency borrowings not being private is the body of regulatory exemption and preferences (REPs) enacted as part of the enabling legislation when an agency was created. The REPs have continued even after an agency went private. These are extremely valuable to the agencies and would be to any borrower. Legislation spelled out a mission for the agency, established regulatory controls, cited the REPs, and provided a small amount of startup capital to the Government. The association, though of a Government mission and sponsorship, weighs heavily in investors' perception. The line of credit to the Treasury, though a small dollar amount, reinforces this feeling. The following listing enumerates the more significant exemptions and preferences. Agency debt is:

- Qualified as a legal investment for Federally supervised institutions; e.g., banks, Federal savings and loans, mutual savings bank, and Federal credit unions.

- o Exempt from state and local taxes.
- o An unrestricted investment by national banks.
- o Eligible to be used as collateral for Federal, state, and local deposits.
- o Eligible to be used as collateral at Federal Reserve Banks.
- o Exempt from the requirement of Securities and Exchange Commission (SEC) registration.

The combination of close historical ties to the Government and powerful regulatory exemptions place the agencies apart from the private sector. The lack of full faith and credit puts them apart from the Government. A realistic appraisal is that agencies are a hybrid of Government and private. Significantly, the market treats them more as Government than private. This is reflected in the fact that in trading rooms, the agency desk is considered part of "Government" tradings. Corporates and Municipals are separate trading departments. A more telling point is that agency debt is not rated by the rating services (e.g., Standard and Poor). Ratings are critical to private corporations. Not carrying a rating and still being considered suitable as a conservative investment reflects the quasi-Government status of agency paper. This allows agencies to have access to capital beyond what would be the case if completely separated from the Government.

In addition to being willing to lend greater sums, the market accepts a lower rate of interest from all agencies than it would if they were private. It is difficult to estimate what rate agencies would pay if they were completely private because there is no exact private counterpart to compare them with. No private corporation has $100 billion of corporate debt publicly held. Aside from the value of the REPs and the Government affiliation, the strength of the secondary market is an attractive aspect of agency debt; lenders appreciate that larger positions have a liquid aftermarket if circumstances should make it desirable to reduce holdings. It is probable that the differential between the agency rate and the private rate would differ for each agency; the value of a lower interest rate stemming from agency status would probably range from 1/2 to 3 percent. To some extent this rate advantage is an accident of history. When agencies were formed, the crucial aspect of mission performance was the availability of credit, and the associated lower cost of credit was not considered significant. At those times the emphasis in financial institutions was on asset management (loans). Only in the last ten years have liability management (deposits, borrowings) and their interest costs become such a critical

factor. While agency status increases the capacity to borrow substantially and reduces interest rate cost, both factors are affected by creditworthiness. FCS, with its conservative balance sheet, might pay 50 basis points over Treasury while FNMA, with its history of operating losses, might have to pay 200 to 300 basis points.

The agencies recognize the significance and value of agency status. When the idea is broached to go completely private, an agency's first response is that without agency status it could not borrow enough to perform its mission. A recent Arthur D. Little study of farm credit financing undertaken by FCS supported the view that less monies would be available. It forecast a shortfall of $44 billion of borrowings by Federal Land Banks by 1990 if agency status were dropped, even if classes of new lenders were sought out and the interest rate on new debt were to go up almost 2 percent.

The agencies feel that the Federal relationship is critical. They defend this relationship in spite of their private status by pointing out that unlike other private entities, they have a positive obligation to perform a mission or allied activities. For example, FCS cannot make routine consumer loans. It should also be emphasized that Federal sponsorship aptly served its purpose. The networks of regional banks under FHLBB and FCA are unique market mechanisms that admirably serve their constituents. As said above, there are no private sector counterparts to these capital gathering systems.

Three agencies account for the overwhelming bulk of agency borrowings. These are the FCS, FHLBB, and FNMA. (SLMA and FHLMC are two other comparable Government-sponsored agencies that issue debt in their own names.)

The following points relate to specifics of these agencies going private.

- FCS -- as cited above in the Arthur D. Little study, the consequences were examined if the Farm Credit System were to lose agency status. There would be $44 billion less of system borrowing. However the principal outcome of this would be that farm land prices would be up to $415 billion less than with continuing agency status but still more than inflation. Additionally, farm income would be higher by .9 percent a year, the food component of the Consumer Price Index (CPI) would be up only 0.1 percent and the dollar volume of exports would be unchanged. (See BANK 39 for details on this and other specifics in regard to privatizing FCS.)

- FHLBB -- Mr. Richard Pratt, the Chairman of FHLBB (and therefore also Chairman of the Board of Directors of FHLMC), was sympathetic to full privatization, as long as it was applied across all similar agency lines, and felt that the technique to accomplish this (detailed below) is practical. (See Document BANK 19).

- FNMA -- FNMA has substantial advantages over private corporations stemming from agency status in the handling of mortgage related instruments. These go beyond simply being able to float more debt at more attractive rates. The fact of these advantages inhibits private corporations from making a large business commitment in the secondary market for mortgages. As a consequence, the agency status of FNMA, while critical for its performance, may reduce liquidity overall in the aftermarket for mortgages. FNMA would like to go fully private but does not want to do so until it has improved its earnings and balance sheet and can compete with better capitalized firms. (See BANK 35 for specifics of the advantages of agency status for FNMA and FHLMC).

In addition to these larger entities, SLMA has hopes of going fully private in the future. FHLMC had legislation introduced on its behalf to accomplish its going private. However, the Administration did not support the bill because FHLMC did not become private enough. Mr. Kenneth Thygerson, President of FHLMC, generally supports the thrust of full privatization and believes the techniques suggested below to accomplish this are practical.

Conclusions

Federally sponsored agencies are neither part of the Government nor part of the private sector. In corporate form they are regular stock companies or cooperatives but in their ability to attract financing, the market treats them as part of the Government more than as private. This dichotomy has led to the following contradiction: The Government does not control agency growth because it is private; but the agencies depend upon Federal sponsorship (i.e., being treated as part of the Government) for their growth. This contradiction has extremely important consequences, now and for the future.

Congress does not regulate growth as a routine matter. Instead, it relies on market forces to limit growth. On this point, the Congress cannot be blamed. There are numerous subtleties making it difficult to appreciate the

workings of the system. Furthermore, the Congress is concerned most with mission performance since the constituency of the subcommittees exercising oversight overlap those of the agencies. The Administration has a regulatory authority but no single organization within the Administration is directly charged with the responsibility to set policy for agencies. Existing authority is viewed as extending more to the mechanics than the policy side of agency oversight. Within the administration, OMB has most actively questioned the propriety of agency growth, but OMB lacks a line responsibility to act.

High rates of growth by agencies exacerbate the fiscal problems caused by large Government deficits. Because Government and agency borrowings compete in the same market, larger agency borrowings increase the rate which the Government must pay for its borrowings. Because agency borrowings are not subject to factors limiting growth in private debt (as demonstrated by the lack of credit rating), excess borrowings lead to misallocation of economic resources; e.g., unrestricted borrowing of the Federal Land Banks results primarily in inflated land values.

In addition to relatively unlimited access to funds, agencies enjoy a rate advantage over what they would pay as a purely private entity. This rate advantage of agency status was neither given much weight nor widely understood when agencies were formed.

Given that growth in agency debt is not under control, what should be done? The agencies maintain that a dramatic change in their circumstances, i.e., complete privatization, would jeopardize their ability to continue the performance of their mission. This may be an exaggeration, but the risk of failure is too great to experiment. (This argument of the agencies admits that claims to pure private status are flawed.) If nothing is done now, and rapid growth continues, changes in the future will be harder to achieve.

Recommendations

BANK 40-1: We recommend that agencies be charged a fee of 5 basis points for the use of agency REPs and Government affiliation for the first year. The fee would be increased each year that the agency retained Government affiliation. When an agency believed it to be in its best interest, it would petition for legislation to allow it to become completely private. The fee could be either on new borrowings or obligations outstanding. Because outstanding debt has a lower interest cost due to agency status, obligations outstanding was chosen. Most agency debt is for less than one year.

There are a number of aspects and features that make this approach practical and fair:

- Initially, the fee would partially compensate the Government for its expense in sponsoring agencies. The expense is the higher rate it must pay for its own borrowings when forced to compete with agency borrowings. In turn the payment would be made by the agency from the rate advantages it enjoys from Government association. The use of the word "fee" reflects that the Government is charging for something of value it contributes.

- It would be a number of years before the cumulative impact of the fees would outweigh the advantages of Government association. This will give agencies time to plan for their transition. For the financially stronger organizations, this would come earlier; the rate advantages of Government association is worth less to them. Each agency would pick the time it felt most opportune to make the break.

- During the transition period, the market mechanism for capital raising would continue unchanged. The change would be apparent to all parties, except the agencies and the Government.

- The present structure forces the agencies to try to maintain their Government dependence while reiterating their privateness when it is in their interest to do so. The recommended approach gives the agencies a reason to adjust attitudes. Many commentators felt that the will of the agencies to go private is the key to their doing so successfully.

Growth in agency borrowings should be subject to an overall systematic review, perhaps as part of the budgeting process. Under this arrangement a fee would still be charged each agency equal to the interest rate advantage the agency obtains from Government sponsorship. The combination of these measures would place a limit on the growth of agency debt, and bring interest rate costs to parity with the private sector while not diminishing the ability for mission performance.

BANK 40-2: The Congress should be requested to mandate that organizations having agency status be allowed to invest only in Government securities unless held pursuant to their mission. This will remove the opportunity for an agency to arbitrage investments against its lower cost of borrowing.

<u>BANK 40-3: The Congress should be requested to eliminate the tax exempt status of agencies</u>. Specifics of this recommendation are contained in BANK 23, 34, and 38.

Going fully private may leave the agencies at a disadvantage relative to other private corporations if there is an understanding they must continue performance of their mission but still have limitations on areas of business opportunity. The actual limitations would be subject to negotiations between the Congress and the agency at the time privatization was introduced. It should be pointed out though that the agencies will enjoy continuing advantages even after their Government sponsorship has ceased, including an infrastructure and market in place, a history of performance that has created customer goodwill, and an image reflecting the blessings of the Government.

Savings and Impact Analysis

The three recommendations are designed to accomplish parity with the private sector and to initiate a move toward full privatization without jeopardizing agency missions. (The alternate recommendation aims toward parity without full privatization.) Increased revenue to the Government would be $120.7 million in the first year of operations based upon obligations outstanding for the largest agencies as of September 30, 1982. Assuming similar levels of outstanding obligations, these user fees would increase to $241.4 million in the second year when the fee would go to 10 basis points and to $362.1 million in the third year when the fee would go to 15 basis points. (If FHLMC and SLMA were included, revenues would be slightly greater). Savings from lower interest rates from reduced agency borrowings cannot easily be estimated and are not included. Revenues from taxing agencies are included elsewhere.

Implementation

Enabling legislation would have to be prepared and enacted.

Exhibit II-23

FEDERAL DEBT — INTEREST-BEARING SECURITIES BY GOVERNMENT AGENCIES
(in $ millions)

End of fiscal year or month	Total Outstanding 1/	Defense Department	Housing and Urban Development Department		Other independent agencies				
		Family housing and homeowners assistance	Federal Housing Administration	Government National Mortgage Association	Export-Import Bank of the United States	Federal Home Loan Bank Board	Postal Service	Tennessee Valley Authority	Other
1974	12,012	1,382	408	4,370	2,894	10	250	2,696	3
1975	10,943	1,276	487	4,260	2,593	-	250	2,075	2
1976	11,433	1,171	581	4,180	3,174	-	250	2,075	2
	11,678	1,136	578	4,145	3,591	-	250	1,975	2
1977	10,298	1,016	579	3,768	2,858	-	250	1,825	2
1978	8,881	897	601	3,166	2,141	-	250	1,825	2
1979	7,232	767	551	3,004	933	-	250	1,725	1
1980	6,616	641	495	2,842	661	-	250	1,725	2
1981	6,086	516	432	2,715	446	-	250	1,725	2
1982	4,952	388	335	2,165	88	-	250	1,725	1
1981-Sept.	6,086	516	432	2,715	446	-	250	1,725	2
Oct.	6,069	514	427	2,715	436	-	250	1,725	2
Nov.	6,021	490	419	2,715	420	-	250	1,725	2
Dec.	5,987	484	413	2,715	398	-	250	1,725	2
1982-Jan.	5,438	470	406	2,191	394	-	250	1,725	2
Feb.	5,118	460	397	2,165	120	-	250	1,725	2
Mar.	5,094	454	382	2,165	116	-	250	1,725	2
Apr.	5,074	447	376	2,165	110	-	250	1,725	2
May	5,050	434	363	2,165	111	-	250	1,725	2
June	5,029	419	358	2,165	110	-	250	1,725	2
July	5,011	408	353	2,165	109	-	250	1,725	2
Aug.	4,981	399	345	2,165	95	-	250	1,725	2
Sept.	4,952	388	335	2,165	68	-	250	1,175	1

Exhibit II-23 (Cont'd)

FEDERAL DEBT -- INTEREST-BEARING SECURITIES ISSUED BY GOVERNMENT AGENCIES
(in $ millions)

End of fiscal year or month				Memorandum -- Interest-bearing securities of non-Government agencies				
	Banks for Cooperatives	Federal home loan banks	Federal intermediate credit banks	Federal land banks	Farm credit banks	Federal National Mortgage Association	Student Loan Marketing Association	District of Columbia Stadium Fund
1974	2,475	18,622	7,995	110,67	-	25,232	-	20
1975	2,896	21,250	9,497	14,192	278	28,237	-	20
1976	3,694	19,390	10,298	10,060	958	29,863	-	20
?	3,901	19,111	10,791	16,566	701	30,685	-	20
1977	4,061	19,206	11,693	18,719	2,008	31,491	-	20
1978	4,317	27,443	11,555	20,198	5,135	38,353	-	20
1979	785	45,518	2,676	17,075	29,297	46,378	-	20
1980	584	54,101	1,821	12,765	45,950	52,382	-	-
1981	220	76,799	1,388	10,317	59,024	56,668	-	-
1982	220	98,911	926	7,652	65,553	68,130	1,611	-
1981-Sept.	220	76,799	1,388	10,317	59,024	56,688	-	-
Oct.	220	76,729	1,388	9,717	60,911	57,803	-	-
Nov.	220	77,460	1,388	9,717	60,191	58,533	-	-
Dec.	220	79,803	1,388	9,717	60,034	58,749	421	-
1982-Jan.	220	80,579	1,388	8,717	61,187	58,860	127	-
Feb.	220	82,191	1,388	8,717	61,041	59,018	175	-
Mar.	220	84,780	1,388	8,717	61,403	59,018	175	-
Apr.	220	88,156	926	8,217	63,381	60,478	290	-
May	220	90,191	926	8,217	63,409	61,996	427	-
June	220	93,354	926	8,217	64,506	62,660	406	-
July	220	95,487	926	7,652	65,657	65,733	690	-
Aug.	220	97,848	926	7,652	65,657	65,733	1,307	-
Sept.	220	98,911	926	7,652	65,553	68,130	1,611	-

Source: Bureau of Government Financial Operations and Monthly Treasury Statement of Receipts and Outlays of the U.S. Government.

Note: The Export-Import Bank was moved within the budget effective October 1, 1976, pursuant to Public Law 93-646. Adjustments are made to include totals for the period it was outside the budget (August 17, 1971, through September 30, 1976). Also, adjustments are made to reflect certain Export-Import borrowing transactions now classified as agency debt. These transactions were previously as off-budget negative outlays.

1/ Includes unredeemed matured securities outstanding on which interest has ceased.

NATIONAL TAXPAYERS UNION

Statement of
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National Taxpayers Union

Before the
Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises
Banking and Financial Services Committee
United States House of Representatives

On
HR 3703. The Housing Finance Regulatory Improvement Act

June 21, 2000

Mr. Chairman, on behalf of the 300,000 members of National Taxpayers Union (NTU), I am deeply grateful for the opportunity you have given my organization to testify before the Subcommittee today on HR 3703 and policies toward Government Sponsored Enterprises (GSEs) involved in housing finance.* By holding these hearings, you have once again demonstrated your concern that Congress fulfill its obligation to effectively oversee not only direct federally-funded programs, but also entities that receive indirect or implicit federal subsidies. Taxpayers across the country are most appreciative that you, Mr. Chairman, and the Members of this Subcommittee have taken the time to give this issue additional exploration.

Introduction

Mr. Chairman, I appear before the Subcommittee today not as a financial services wizard or as a political insider, but rather as an institutional historian. As you know, NTU has long expressed concern about the potential risks to taxpayers posed by GSEs.

Since the early 1970s, my organization has compiled a "Taxpayer's Liability Index" that tracks federal financial obligations above and beyond the national debt. That analysis has continually pointed to an expanding level of potential taxpayer costs associated with GSE debts.

* National Taxpayers Union does not solicit or accept any form of government funding. In 1999 National Taxpayers Union received no federal grants. NTU has prepared and delivered this testimony solely on behalf of its 300,000 members.

Our Founder and Chairman Emeritus James Davidson testified before the House Ways and Means Committee on this topic in September 1989, at what was then billed as the "first oversight hearing on GSEs in recent memory."

Throughout the early 1990s, NTU actively sought GSE oversight legislation in Congress, and pointed to the unfairness of rising compensation packages among senior GSE officials while the entities they managed were enjoying taxpayer subsidies.

Also during that period, our research affiliate, NTU Foundation, sponsored a well-attended Washington, DC policy conference, "A Crisis in Values." The event brought together the top experts in the financial industry to discuss the role of the real estate economy in the S&L Crisis and in the potential liabilities of GSEs.

Earlier this year, NTU organized a Capitol Hill conference entitled "Fannie Mae & Freddie Mac – Issues for Taxpayers," which featured diverse authorities on Government-Sponsored Enterprises that included: Peter Wallison, former General Counsel for the Treasury Department and current Resident Fellow at the American Enterprise Institute; Bert Ely, a longtime financial institutions consultant who was one of the first to predict the massive S&L bailout; Steve Moore of the Cato Institute and Tom Miller of Competitive Enterprise Institute, whose organizations have tracked GSE liabilities; and, Betsy Hart, a syndicated columnist who has investigated the political activities of Fannie Mae and Freddie Mac.

Given this lengthy history, NTU's positions on GSEs and possible reforms have transcended, and will continue to transcend, any existing political or fiscal environment.

At this point, Mr. Chairman, I wish to mention that NTU and NTU Foundation have extensive information on GSE-related issues available online at www.ntu.org. Naturally, it would also be our great pleasure to furnish you and your colleagues with any additional archived materials from earlier events upon your request.

To briefly summarize our concerns:

- According to Congressional Budget Office methodology, Freddie and Fannie's 1999 federal subsidy was $10 billion, $3.5 billion of which benefited their stockholders and managers.
- But in order to keep earnings growing by 15% per year, the two quasi-private firms must resort to increasingly risky practices, such as fishing into the consumer credit and jumbo mortgage pool, holding derivatives, and conducting interest-rate swaps.
- GSE debts and liabilities, which most capital markets assume to be backed by the federal government, is estimated to be at least $1.4 trillion and as much as $2.6 trillion. This level would be 12-20 times the amount of on-balance-sheet

debt carried by the ill-fated private firm Long Term Capital Management when it crashed.

No less than Federal Reserve Chairman Alan Greenspan forcefully drove home the implications of these issues when he recently wrote to the Subcommittee that:

> Federal government guarantees -- implicit or explicit -- are one way, along with government outlays and mandates on the private sector, that the federal government makes claims on the real resources of the private sector. Subsidies accorded to GSEs are, of necessity, at the expense of other federal or private sector initiatives and hence are ultimately financed by households, either through taxes or through the reduced accumulation of wealth.

In the past, NTU's forums and committee appearances have generated discussion over a range of possible reforms to Fannie Mae and Freddie Mac, such as:

- The government could levy a GSE "user fee" that would reflect the subsidy margin that Freddie and Fannie enjoy over private lenders;
- Freddie and Fannie could be re-federalized and re-structured to perform a more limited role as strictly a low-income mortgage underwriter;
- Competing GSE housing finance franchises could be auctioned off in a manner similar to the successful FCC spectrum auctions;
- A targeted housing finance tax credit could replace the lender-of-last-resort practices of the GSEs, thereby preventing much of their housing market price distortions;
- Privatize the GSEs entirely, along the lines of the Student Loan Marketing Association.

These types of changes are well beyond the scope of HR 3703, and I have provided them partially as background for Members of the Subcommittee. However, it is also our hope that mentioning these proposals, and noting their absence in HR 3703, will underscore what should be the non-controversial nature of the legislation presently under consideration by the Subcommittee. Far from initiating some sweeping overhaul, HR 3703 merely seeks to consolidate and improve Congress's existing mission to oversee the operations of the housing GSEs.

Familiar Echoes from the Past: S&Ls

Members of this Subcommittee are now in the midst of a third round of hearings on housing GSEs, and many of the arguments taxpayer advocates are raising today may seem shopworn. Officials with the GSEs themselves dismiss any analogy to a possible "2nd S&L Crisis" as ill-informed, or unfitting, or even alarmist. It is this historical nexus to present-day GSEs, and its considerable merit, that will constitute the remainder of my testimony.

No history of political institutions can ever be completely objective, especially when recounted from the viewpoint of an interested organization. However, one can make great strides toward objectivity in drawing parallels between the S&L Crisis and GSEs by employing tracts from other official sources.

A helpful document in this regard is *Origins and Causes of the S&L Debacle: A Blueprint for Reform.* Prepared by the National Commission on Financial Institution Reform, Recovery, and Enforcement [hereafter known as "the Commission"] pursuant to Public Law 101-647, the report identified "conditions necessary for the [S&L] collapse to occur, causes precipitating the collapse, and factors intensifying and prolonging losses once the process was under way." Some of the Commission's findings, which I quote in pages to follow, provide useful points for comparison.

1) "**Fundamental condition necessary for collapse** – *Federal deposit insurance on accounts at institutions was at the heart of it.* With federal deposit insurance, S&Ls attracted large quantities of deposits at a subsidized rate and invested these funds in risky activities."

Market discipline cannot prevail if Congress allows the institutions it creates to privatize profits but socialize risks. In an unsubsidized environment, S&L consumers would have helped to act as "self-regulators" against institutions that invested deposits in risky portfolios. They would either demand a better interest rate or would simply move their deposits to a "safer" institution. But by raising the per-account insurance limit to $100,000, and by failing to introduce adequate risk-based deposit insurance premiums, the Commission concluded that the government created an environment in which "depositors could benefit with no meaningful risk of financial loss."

Although not mandated to do so by law, the federal government does effectively extend a sort of "deposit insurance" to housing GSE shareholders, in the form of an implicit bailout guarantee. GSE officials have tended to downplay this connection, and cite legal requirements to inform investors that their securities are not backed by the full faith and credit of the United States. The Congressional Budget Office, not known to express unsupported opinions, disagrees with the officials' claims:

> Short of placing an explicit guarantee on the securities of the housing GSEs, the law could hardly be more clear: the government's financial interests in the safety of Fannie Mae and Freddie Mac ensure that their obligations are safe from the risk of default. Although the federal guarantee is only implicit, the financial markets grant "agency status" to the securities issued by GSEs on the basis of those statutory provisions, as though the enterprises were part of the federal government ("Assessing the Public Costs and Benefits of Fannie Mae and Freddie Mac," May 1996).

Ironically, some of the few seeds of doubt that do exist over the GSEs' taxpayer-backed status were sowed by the GSEs themselves. In a summer 1998 article he wrote for *Brookings Review*, Harold Seidman recounted just a few of these bizarre turnabouts:

> [W]hen HUD Secretary Patricia Harris directed FNMA to increase its percentage of mortgage purchases in central-city areas, the agency insisted it was private … [and] that its primary obligation was to its stockholders … FNMA argued no less vigorously that it was a federal instrumentality when New York State attempted to compel it to pay interest on its escrow funds. [And when the Reagan Administration proposed] to cut off its special privileges … FNMA protested that 'Congress established Fannie Mae to run efficiently as an agency, not as a fully private company.'

Indeed, even the boundaries of *explicit* federal guarantees are fluid. In one of the first landmark bank bailouts of modern times, Continental Illinois, the government not only reimbursed insured depositors for their losses, but it also covered the losses of uninsured depositors and creditors of the parent holding company. If Washington cannot exercise fiscal discipline within clearly established limits on its own largesse, there is little chance it will do so in a situation where the taxpayers' checkbook is left wide open.

With implied federal guarantees, a very important incentive for prudent risk-taking is removed. In a truly private-sector corporation, owners and managers face the harsh reality of severe financial losses or bankruptcy if excessive risks are undertaken. Earning the kind of record profits that the GSEs proudly celebrate is far less difficult when someone else can pay the bills for any potential losses.

This was precisely the reason why S&Ls accumulated investments in such capricious markets as real estate development and interest rate speculation. Socializing the risk behind those investments freed the S&Ls from many prudent business constraints, and allowed the industry to grow by a spectacular 56 percent from 1982 to 1985. These explosive growth rates are being matched today by Fannie Mae through other riskier business ventures, such as consumer credit, jumbo mortgages, and derivatives.

2) "**Factors precipitating the collapse** – *The macro-economic shock of unprecedented high interest rates adopted to combat soaring inflation during 1979-82* was a prime factor in precipitating the collapse of the S&L industry."

Due to their initial regulatory charters and later their habits of business, Savings and Loan institutions tended to operate in a "niche market" of long-term mortgages with fixed interest rates. This situation rapidly changed in the late 1970s and early 1980s, when interest rates began to soar. The income earned on most assets held by S&Ls was often outstripped by the outgo they were forced to offer depositors in order to remain economically attractive. This in turn led S&Ls to disastrous attempts to "grow their way

out" of their profitability problems by seeking more profitable, but more volatile, investment options for their assets. Although the resulting taxpayer bailout for these ill advised – and sometimes fraud riddled – decisions could have been ameliorated by earlier and aggressive oversight, the root of the problem for S&Ls remained their vulnerability to downturns in a single economic sector.

GSEs have not been immune to this perilous phenomenon. By its very nature, the Farm Credit System (FCS) concentrated its lending in agricultural activities and was particularly exposed to risks in that sector. Yet, the normal market forces that would compel a private firm to make tough business decisions did not apply to FCS.

In comments about an article he co-wrote for the July/August 1989 edition of *Public Administration Review*, Tom Stanton noted that "even after the farm credit system recorded $4.6 billion of losses in 1985 and 1986, Farm Credit securities remained eligible investments for AAA-rated debt." What private corporation could post losses like these and still retain a debt rating like this? Certainly not one backed by investors instead of taxpayers. No matter – the "investors" who guessed the FCS wouldn't be allowed to fail were duly rewarded, when Congress provided special assistance through the Agricultural Credit Act of 1987.

If a new interest rate crisis were to affect Fannie Mae adversely, history would be repeating itself, not just inflicting itself on a new victim. According to the 1996 Congressional Budget Office Report cited earlier:

> The rapid and sustained rise in interest rates that occurred in the late 1970s and 1980s vividly demonstrates the destructive potential of interest rate risk on debt-financed mortgage portfolios. ... [A]s interest rates rose, borrowers were less likely to prepay their mortgages. ...By the early 1980s, the market value of Fannie Mae's mortgages was $10 billion less than its outstanding debt. By that measure, Fannie Mae was insolvent. Eventually, interest rates declined, and Fannie Mae recovered.

Earlier this summer Treasury Under Secretary Gensler reiterated this observation in his own testimony, when he noted that Fannie was put in a bind "similar to that faced by the Savings and Loan industry. Fannie Mae became insolvent on a mark-to-market basis."

Fannie Mae's first reprieve from the fate suffered by many S&Ls has resulted in a different management style. Interest-rate risk has been balanced so far through issues of long-term callable debt, short sales of Treasury securities, and derivatives. Such practices are not inherently wrong, but some of them *do* make, as CBO noted, "the assessment of total risk exposure more complex for both management and the federal government."

Housing GSEs can also resort, within limits, to diversifying their holdings or services. However, there are few worlds left to conquer within a literal reading of their

charters. Today, Fannie and Freddie dominate the retail market mortgage market by owning or guaranteeing 40 percent of all mortgages. Together they have approximately 65 percent of market value for mortgage intermediary services and almost 100 percent of the market for securitizing conventional mortgages.

If Freddie and Fannie do not expand their pool of borrowers, they are likely to experience "mission creep" as they compete for other services, such as home equity loans. As Jeffrey Zeltzer, Executive Director of the National Home Equity Association, has stated, "The home equity area is a refinancing of consumer debt, or a home improvement, or sending someone to college, or a family medical emergency. So they're not even within the mission."

In attempting to avoid a repeat of the S&L Crisis or its own insolvency during the 1980s, Fannie Mae (along with other housing GSEs) has created a long-term dilemma that taxpayers and policymakers must eventually confront. Diversifying portfolios within their mission risks concentration of entire lending sectors, not to mention the use of complex financial instruments for which private investors and companies can pay steep "opportunity costs." Diversifying portfolios outside of their mission risks a sort of "industrial policy" that could unintentionally put large sectors of our economy under the control of entities that enjoy a substantial public subsidy over their private rivals.

Do Americans really want to import the kind of system now evolving in China, where branches of its national government are investing as if they were multinational corporations? We think not.

3) "**Factors intensifying and prolonging the collapse** – *A systematic breakdown in the political system* involving Congress, the independent regulators and the Administration prevented corrective actions."

To be clear, the S&L Crisis involved a share of abuse and fraud among operators of those institutions that would not be found at all among the managers of housing GSEs. Nonetheless, the regulatory process does not merely concern itself with uncovering or punishing illegal acts. It establishes guidelines, provides reporting standards, and creates a rudimentary "alarm system" designed to alert lawmakers and the public to the need for their involvement in drafting reforms. It is in the latter areas that a comparison between S&Ls and GSEs remains appropriate.

According to the Commission, regulators were often blinded to the poor business practices of certain S&Ls due to "the absence of an information structure that obscured the extent of the mounting losses and the degree to which the federal deposit insurance program and the Treasury were exposed to loss."

Despite recent efforts to establish reporting and capital standards for the housing GSEs, transparency is still an elusive goal. GSEs can trade on the New York Stock Exchange, but are exempt from Securities and Exchange Commission fees and reporting requirements that burden other companies that offer stock. Nor are the GSEs required to disclose trading positions held by their top-level managers.

Another element of transparency, capital hedges against risks, illustrates the critical policy juncture we have now reached. In 1992, the Federal Housing Enterprises Safety and Soundness Act of 1992 instructed a newly-created Office of Federal Housing Enterprise Oversight (OFHEO) to develop risk-based capital standards to apply to GSEs. Progress on this front has been painfully slow. Fannie Mae could not meet a "test run" of a proposed OFHEO risk-based capital rule in 1997.

The limited standards for GSEs that exist today, which are not necessarily risk-based, point to a major advantage vis-a-vis their competitors. Private banks and thrifts must maintain at least 4 percent capital against on-balance sheet assets as well against any "prudent" mortgage-related assets, on- or off-sheet. The total risk-based capital minimum for on-balance and off-balance sheet assets is 8 percent.

In contrast, Fannie Mae and Freddie Mac fall under just two established core requirements – 2.5 percent for on-sheet assets and .45% against off-sheet assets. A risk-based standard has not yet been implemented by outside regulators.

Senior GSE officials contend that their agencies are in a far better position than most private financial institutions, and that the existing standards are fair given the structure of the GSEs' holdings. However, outside analysts seem unable to verify these claims with any certainty. Fannie Mae insists it has developed its own "internal" risk-based capital model that purportedly complies with the intent of the 1992 law, but without a detailed analysis of this model, taxpayers remain unassured.

Conclusion: A Sustainable Future Must Build on Lessons of the Past

The "Summary and Recommendations" section of the Commission's report begins with the historical observation that "Congress transformed S&Ls into agents of national housing policy" and that "government regulation sheltered S&Ls from competition, allowing the industry to be profitable and failures to be rare." But beginning with the interest rate problems of the 1980s, the Commission found policymakers to be "ill-prepared to deal with the crisis." The result was "a large and unnecessary expense to taxpayers" that "has shaken the public confidence in financial institutions, government, and the political process." This need not be the case with other Congressionally-chartered "instruments of national housing policy," the GSEs.

More than a decade ago, NTU Founder James Davidson began his presentation to the Committee on Ways and Means by prophetically observing that:

> [D]espite dramatic increases in borrowing by GSEs, too little is known about the magnitude of the very real risks underwritten by American taxpayers. One of the unfortunate lessons of the Savings and Loan [S&L] debacle is that off-budget activities, loan guarantees, and quasi-government functions can have a tremendous impact on the federal budget... Should a similar fiscal catastrophe hit GSEs, bailout costs could multiply to levels that would not currently seem credible...Given these risks, it is absolutely essential that the Congress be provided with accurate information concerning the potential costs of GSEs to the federal government.

Unfortunately, the strong, permanent framework of oversight our Founder envisioned has yet to evolve. Granted, government studies of the impact of housing GSEs on the federal balance sheet have significantly informed the debate over the past decade. In addition, preliminary efforts to establish a free-standing structure of standards and reviews are underway. Yet these developments have only served as a foundation upon which Congress must now build. HR 3703 would continue the construction process, and for this reason alone it deserves the support of the Subcommittee and your colleagues throughout the House and Senate.

In closing, Mr. Chairman, I thank you and all the Members of the Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises for your initiative and leadership in holding these vital hearings. I look forward to answering any questions you may have.

NATIONAL TAXPAYERS UNION

A NONPARTISAN, NONPROFIT ORGANIZATION DEDICATED TO THE PUBLIC INTEREST

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Statement of

James D. Davidson
Chairman
National Taxpayers Union

before the

Subcommittee on Oversight
Committee on Ways & Means
U.S. House of Representatives

on

Government Sponsored Enterprises

September 28, 1989

Mr. Chairman and members of the Subcommittee, thank you for the opportunity to present testimony on Government Sponsored Enterprises (GSE). I commend the Subcommittee for holding the first oversight hearing on GSEs in recent memory.

We sincerely appreciate the work of Congressmen J.J. Pickle and Bill Gradison, the other members of this Committee and the outstanding staff to enact a provision in the Financial Institutions Reform, Recovery and Enforcement Act to require a study by the Treasury Department assessing the financial safety and soundness of GSEs. This study is a very important step for fiscal responsibility.

Borrowing by GSEs has increased from $175 billion in 1980 to $721 billion in 1988, outpacing even the skyrocketing increase in the national debt. Yet despite dramatic increases in borrowing by GSEs, too little is known about the magnitude of the very real risks underwritten by American taxpayers.

One of the unfortunate lessons of the savings and loan debacle is that off-budget activities, loan guarantees, and quasi-government functions can have a tremendous impact on the Federal budget.

The Federal government stands behind approximately $2.7 trillion of deposits at banks and savings and loan institutions. American taxpayers face $160 billion and probably more in bailout costs for deposit insurance. Should a similar fiscal catastrophe hit GSEs, bailout costs could multiply to levels that would not currently seem credible.

Given these risks, it's absolutely essential that the Congress be

provided with accurate information concerning the potential costs of GSEs to the Federal government. It's entirely appropriate that the Treasury Department prepare such a study. Perhaps it can apply the knowledge it gleaned from its experience in the savings and loan crisis.

It is very important that the Treasury Department devote the staff resources necessary to do a first class job in preparing this study. Tens of billions of dollars could be at stake.

We intend to carefully watch the progress being made by the Treasury Department on this important report.

Government Sponsored Enterprises - What are they?

Harold Seidman, writing in the summer 1988 Brookings Review, describes a GSE as an organization with "non-government status and exemption from most, but not all, laws and regulations applicable to federal agencies, officers and employees. The exemption does not mean, however, that government-sponsored enterprises are subject to the laws and regulations applicable to comparable organizations in the private sector - many are expressly exempted from those laws and regulations."

An article by Ronald Moe and Thomas Stanton in the July/August 1989 Public Administration Review defines a GSE as "a privately owned, federally charted financial institution with nationwide scope and limited lending powers that benefits from an implicit federal guarantee to enhance its ability to borrow money." This definition clearly shows the inherent danger of GSEs.

GSEs often use this legal ambiguity to have it both ways. Seidman noted that "when HUD Secretary Patricia Harris directed FNMA to increase its percentage of mortgage purchases in central-city areas, the agency insisted it was private . . . [and] that its primary obligation was to its stockholders. . . . FNMA argued no less vigorously that it was a federal instrumentality when New York State attempted to compel it to pay interest on its escrow funds. [And when the Reagan Administration proposed] to cut off its special privileges . . . FNMA protested that 'Congress established that Fannie Mae to run efficiently as an agency, not as a fully private company.'"

The most important feature of GSEs is the implicit Federal backing of their debts. Although some GSEs are required by law to explicitly state that their obligations are not guaranteed by the Federal government, investors believe there is a de facto Federal guarantee. The spread between Treasury and GSE debt is typically between 30 and 50 basis points, far lower than the spread between the highest quality corporate and Treasury debt.

It's not surprising that investors would come to such a conclusion. I've reprinted a table from Special Analysis F of the fiscal year 1990 budget that outlines some of the benefits enjoyed by

GSEs. Virtually all GSE debt is exempt from Securities and Exchange Commission registration requirements and various state securities laws. The debt also has equal standing with Treasury debt as investments for banks and other financial institutions.

Stanton notes that "even after the farm credit system recorded $4.6 billion of losses in 1985 and 1986, Farm Credit securities remained eligible investments for AAA-rated debt." What private corporation could record such massive losses and retain a similar debt rating? None.

The investors who assumed a de facto Federal guarantee were right. Congress provided special assistance to the Farm Credit System in the Agricultural Credit Act of 1987.

The Risks of Government Sponsored Enterprises

Congress has shown the willingness to bail out GSEs, putting America's taxpayers at risk and raising the ultimate danger of GSEs.

Although the risks are apparently borne by the Federal government, the benefit and the profits accrue to private investors. This creates a "heads we win, tails you lose" scenario for taxpayers.

<u>Credit guarantees, real or implied, are not free</u>. With these risks, there are costs. Due to the size of GSEs, when there is a failure, the costs will be large. With the lack of information on GSEs, the problems may well also come as a surprise to the Congress.

With implied Federal guarantees, a very important incentive for prudent risk taking is removed. In a truly private-sector corporation, owners and managers face the discipline of severe financial losses or bankruptcy if excessive risks are undertaken.

Stanton describes this loss of discipline in his report for the Association of Reserve City Bankers, <u>Government Sponsored Enterprises: Their Benefits and Costs as Instruments of Federal Policy</u>:

> For the usual company, debtholders and purchasers of guaranteed securities will limit the degree of risk by demanding increasing returns for themselves as shareholders increase risk and attempt to increase leverage. For the enterprise with implicit government backing, this constraint is largely gone. Shareholders of a government sponsored enterprise can increase their returns by increasing risks and can leverage these benefits by greatly increasing the ratio of outstanding debt to shareholder equity. <u>The federal government receives no compensation for bearing</u>

increased risks for enterprise activities, but has potential unlimited liability if an enterprise fails. [Emphasis added.]

Indeed, the Congressional Budget Office director Robert Reischauer reported to the Ways & Means Committee this spring that "Fannie Mae's capital-to-asset ratio, which is only 2.1 percent measured on a book-value basis, is low for a portfolio mortgage lender, even one with a large mortgage-backed securities business."

Undoubtedly, Fannie Mae will report to the Subcommittee today that it is earning record profits. But will Fannie Mae report the level of risks involved in those profits? Will it quantify the implicit federal subsidy that artificially boosts these profits?

Another element of risk for the Federal government is that GSEs typically concentrate their borrowing in one area of economic activity. For example, the Farm Credit System concentrates its lending in agricultural activities and is particularly vulnerable to the health of the agricultural sector. Private sector corporations can reduce their risks by diversifying their portfolios.

Privatizing the Profits and Socializing the Losses

The prevailing view in Washington is that no economically significant bankruptcy can be tolerated. That was the case with the Farm Credit System and also with the failure of Continental Illinois Bank, when the government bailed out not only insured depositors but uninsured depositors and creditors of the parent holding company. The trouble with this philosophy of finance is, of course, that it is an invitation to total ruin. Market discipline is ineffective when Congress privatizes the profits but socializes the losses. Everyone cannot be bailed out by everyone else, just as climbers who are tied together by a safety line cannot all fall off the mountain at once and be held aloft by one another. For the rescue to work, someone must be clinging to a solid handhold above the ravine. The greater the weight tugging on a safety line, the greater chance that everyone will tumble together.

Severe Fiscal Danger from a Real Estate Price Decline

The risks in the government's credit guarantees are not only hidden from plain view, they are concentrated to a startling extent. A great many could have the common feature of being triggered by a fall in the price of real estate. Merely regional declines in real estate have already necessitated an S&L bailout that will cost a minimum of $166 billion, and probably much more. This happened while real estate in most regions remained healthy. A generalized fall of real estate prices would escalate the cost of S&L guarantees by more hundreds of billions, while also undermining the recovery value of the FDIC's huge real estate portfolio.

Banks and S&Ls are not the only real estate investors. Even many of the supposedly uninsured lenders and owners, such as insurance companies and pension funds, cannot lose in a big way without transferring their liabilities to the Treasury through the Pension Benefit Guarantee Corporation.

Of course, a decline in real estate values would also send shock waves through various GSEs and government agencies including the three-quarters of a trillion dollars in guarantees of mortgages through the FHA, Freddie Mac, Fannie Mae, Ginnie Mae, the VA, Farm Credit System and the Farmers Home Administration. Even Sallie Mae, the student loan enterprise, advances funds to lenders based on home equity loans as collateral.

It isn't necessary to imagine a doomsday scenario in which all loans go bad at once, to reach a point where the ability of the Treasury to meet its liabilities at affordable interest rates would be overwhelmed. In effect, the U.S. Treasury is like an insurance company that has not set aside adequate reserves. It has written trillions of dollars of coverage against the fall of real estate prices in the U.S. If real estate weakens broadly, the consequences could be more serious than anyone in Congress now imagines.

To put it another way, the government is like a highly leveraged futures trader who has bet the whole wad on the proposition that a certain price will rise. Yet in this scenario, if the price rises, the private owners make the profit. If the market goes the other way, and the price falls too far, the power of leverage could be brought into play to create losses of an unmanageable kind for the Federal government. The U.S. Treasury has written history's biggest put option on real estate.

Who's Minding the Store?

Another element of increased risk for taxpayers is the lack of effective regulation of GSEs. Sallie Mae has no financial regulator at all. With all due respect to Secretary Jack Kemp, the Department of Housing and Urban Development is not likely to be an effective regulator of Fannie Mae and Freddie Mac.

Indeed, the General Accounting Office reported in 1985 that "HUD officials do not believe the Department presently has the capacity or expertise to perform certain functions which might be expected of a financial institution regulator such as monitoring FNMA's interest rate risk." The situation has not noticeably improved.

Recommendations for Reducing Federal Risk & Taxpayer Liabilities

1. Complete a first rate study of the safety and soundness of GSE borrowing. The Subcommittee's actions today should be extremely helpful to ensure that the Treasury Department understands the importance of this study to fiscal responsibility.

2. Mandate annual reports on the contingent liabilities of the Federal government from GSEs. Currently, the special analyses volume of the Federal budget and the annual Statement of Liabilities and Other Financial Commitments of the United States Government published by the Treasury Department do not include estimates for contingent liabilities of GSEs because there's no explicit guarantee. That is no excuse for not having the information. Congress has chartered these GSEs, and it ought to receive timely and accurate information on the risks these entities are incurring. Given congressional willingness to assist faltering or failing GSEs in the past, Congress ought to monitor the safety and soundness of these institutions.

3. Assign a value to the risks incurred by GSEs. Some portion of the portfolio of each GSE should be guaranteed by private insurers. Of course, that fraction of the portfolio must represent the entire portfolio and not just the safest investments. This will help establish a budget cost for guarantees which should be included in annual outlays. Gorbachev has written a long endorsement of full cost accounting. The Congress should insist that we do no less. It is financially unsound to employ credit guarantees as an apparently costless alternative to direct outlays. All guarantees have a cost and that cost should be reflected in the budget.

4. Explore the feasibility of requiring GSEs to purchase private insurance for all borrowing. There are several advantages to requiring such insurance. Most importantly, the risks would be transferred form the Federal government and the taxpayer to the private sector.

The premiums for such insurance would very quickly reflect any change in risk because the institutions providing the insurance guarantees would have their money at risk.

Most of the insurance would probably take the form of standby letters of credit whose prices would reflect the amount of risk incurred by the GSE. The GSEs would be closely monitored by the insurers. They would have the financial sophistication and incentive to watch GSE lending practices closely. After all, if the loans go bad, the insurer must make up the difference. There can be little doubt that such insurers would outperform Federal regulators in supervising GSEs.

5. Establish effective Adminstration Oversight of GSEs. Moe and Stanton harshly criticize, and rightly so, the current GSE regulatory

structure. They report that the "regulators generally lack sufficient resources to supervise the finances of these multi-billion dollar institutions; a GSE regulator such as the U.S. Department of Housing and Urban Development is neither oriented to, nor staffed for proper supervision of the safety and soundness of a huge financial institution such as Fannie Mae. Also, their regulatory mandate is vague, and this has led several regulators to slight safety and soundness in favor of other policy goals."

Moe and Stanton suggest delegating to a single administrative agency headed by "a single administrator the authority to regulate, examine, and enforce compliance through appropriate measures to assure safety and soundness." We agree.

6. <u>Place meaningful limits on GSE risk taking incentives.</u> While the requirement that GSEs purchase private insurance to protect against defaults would be a superior method to protect against taxpayer bailouts, meaningful government supervision for all GSEs would prove beneficial.

<u>Supervision must include meaningful capital requirements for GSEs.</u> Such capital requirements would help give the shareholders some incentive to guard against excessive risk taking.

<u>It is crucial that market value accounting be used by GSEs.</u> Historical cost accounting can hide huge losses on nonperforming loans that have lost much of their value, or hide a severe loss in a portfolio subject to interest rate risk. If capital standards are based on historical costs, bad loans will be hidden and capital standards will not offer adequate protection for taxpayers.

<u>Finally, regulators must be required to act should capital standards fall below defined levels.</u> Such mandatory requirements would help insulate regulators from political pressures to look the other way.

7. <u>Full privatiztion of certain GSEs should be considered.</u> The best way to protect against a government bailout of a GSE is to privatize it fully. By doing so, the shareholders and other market investors will understand that the GSE no longer enjoys special privileges. This return to market incentives and discipline should protect against both excessive risk taking and congressional action to bail out the GSE should trouble arise.

We understand that some of these reforms may take several years to adopt. In any event, the initial requirement that the Treasury Department prepare a report on the safety and soundness of GSEs is a constructive first step toward fiscal responsibility. Without reliable information, it will be difficult for Congress and the Administration to understand GSEs or the risks involved for the taxpayers of this country.

Table F-8. SOME BENEFITS ENJOYED BY GOVERNMENT-SPONSORED ENTERPRISES

Type of Benefit	FCS	FCSFAS	FAMC	FHLB	FHLMC	FICO	FNMA	SLMA	CCLIA
CHARACTERISTICS									
Ostensible ownership	Private	Federal & Private	Private	Private	Private	Federal & Private	Private	Private	Federal
Principal source of capital	Private	Federal & Private	Federal & Private	Private	Private	Federal & Private	Private	Federal & Private	Federal & Private
Who bears ultimate financial risk	Federal & Private	Federal	Federal & Private	Private	Private	Private	Federal & Private	Private	Federal & Private
Selection of top managers	Private	Private	Federal & Private	Federal & Private	Federal & Private	Federal & Private	Federal & Private	Federal & Private	Federal & Private
Control over budget/personnel	Board	Board	Board	Board	Federal	Board	Board	Board	Board
Subject to GAO audit	No	No	Yes	Yes	No	Yes	No [1]	No	No
Subject to Federal pay limits	No	No	No	No	No	n/a [2]	No	No	No
Obtain financing through exercise of sovereign power	No	No	No	No	No	No	No	No	No
Subject to OMB apportionment	No	No	No	No	No	No	No	No	No
BENEFITS ENJOYED									
Line of credit at Treasury	Yes	Yes	Yes	Yes	Yes [3]	No	Yes	Yes	No
Exemption of corporate earnings from Federal income tax	Yes [4]	Yes	No	Yes	No	No	No	No	No
Exemption of interest income of investors from State and local income taxes	Yes	Yes	n/a [5]	Yes	No	Yes	No	Yes	n/a [5]
Eligibility for Federal Reserve open market purchases	Yes	n/a [5]	n/a [5]	Yes	Yes	n/a [5]	Yes	Yes	n/a [5]
Equal standing with Treasury debt as investments for most banks	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	n/a [5]
Exemption from SEC registration and various State banking laws	Yes	Yes	No [6]	Yes	Yes	Yes	Yes	Yes	n/a [5]
Eligibility as collateral for public deposits	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	n/a [5]

[1] Except for GNMA.
[2] No staff.
[3] Indirect line of credit through the FHLBs.
[4] Federal Land Banks and Farm Credit Banks.
[5] Entity newly created.
[6] Mortgage-backed securities may be exempt from State banking laws.

FCS – Farm Credit System
FCSFAS – Farm Credit System Financial Assistance Corporation
FAMC – Federal Agricultural Mortgage Corporation
FHLB – Federal Home Loan Bank System
FHLMC – Federal Home Loan Mortgage Corporation (Freddie Mac)
FICO – Financing Corporation (1987 FSLIC Recapitalization Act)
FNMA – Federal National Mortgage Association (Fannie Mae)
SLMA – Student Loan Marketing Association (Sallie Mae)
CCLIA – College Construction Loan Insurance Association (Connie Lee)

Dollars & Sense

TAXPAYER BAILOUTS MULTIPLY

NEWS NOTES

Warnings from NTU about the liability posed by Government Sponsored Enterprises (GSEs) have been borne out by recent revelations of another federal loan program about to soak taxpayers.

Latest of the casualties is a program run by the Small Business Administration to finance small business investment companies. These entities raise equity capital from private investors and combine it with federal–guaranteed loans, often borrowing up to three times their private capital.

. . . from student loans to farm credit, borrowing has increased alarmingly from $175 billion in 1980 to $721 billion in 1988.

Since 1980 program losses skyrocketed 382 percent, presenting a bill to taxpayers that may reach $800 million. These thinly–capitalized entities were leveraged–up with federal loan guarantees, forcing taxpayers to assume the risks without the prospect of benefits.

"This philosophy is an invitation to total ruin," says NTU Chairman James Davidson. "Market discipline is ineffective when Congress privatizes the profits but socializes the losses."

Across the broad spectrum of GSEs, from student loans to farm credit, borrowing has increased alarmingly from $175 billion in 1980 to $721 billion in 1988. Congress has repeatedly shown a willingness to bail out GSEs, such as its action in 1987 to cover $4.6 billion in losses by the farm credit system.

Will Congress ever show a similar readiness to lessen taxpayer liabilities in connection with GSEs? That will depend on the support NTU members give in our attempts to alert the public and pressure the Congress to act. ■

Outstanding GSE Credit Market Borrowing
(end of calendar year, $ billions)

	1970	1975	1980	1985	1986	1987	1988	1989	Growth Rates 1970–80	Growth Rates 1980–89
Fannie Mae	15.2	31.6	72.3	194.4	262.8	309.7	331.9	389	13.8	20.56
Freddie Mac	****	4.1	4.6	66.8	110.6	157.5	203.1	252.3	****	20.2
FHL Banks	10.5	16.4	37.3	74.4	88.8	116.4	136.5	136.1	13.5	15.5
Farm Credit System	13.2	28.4	63	69.1	62.3	55.2	54.6	56.6	16.9	−1.2
Farmer Mac	****	****	****	****	****	****	****	****	****	****
Sallie Mae	****	****	****	8.6	12.2	16.5	22	28.6	****	****
Connie Lee	****	****	****	****	****	****	****	****	****	****
TOTAL GSE	38.9	80.5	177.2	413.3	536.7	655.3	748.1	862.6	16.4	19.2

**** GSE not generating credit market debt as of this date

SOURCE: GSE balance sheets and Federal Reserve Board Flow of Funds Data.

Dollars & Sense

You Can Make A Difference

NTU to Sponsor National Taxpayers Conference

A national conference for state and local taxpayer organizations will be sponsored by NTU in Washington this fall. NTU held the first such conference in Saint Louis in December of 1989. The success of that conference has generated many requests for a repeat. On September 21 and 22, James Davidson and David Keating will lead the two–day workshop in exploring current tax issues, waging campaigns against tax increases, reducing existing tax burdens and fighting government waste at the state and local level.

Leaders of successful state organizations will share their winning strategies in building successful coalitions, lobbying the legislature, and fundraising strategies.

Further details of this important event will be published in the June issue of *Dollars & Sense.* But now is the time to begin making your plans to join this select group of experts and national leaders who will give you fresh ideas, new contacts and provide you with the means to determine the fiscal future of your community and the nation. Plan to join us in Washington, D.C. September 21 and 22 ■

September is the month to learn how YOU CAN make a DIFFERENCE!

Fat Fannie

The Washington Post discovered recently that the Federal National Mortgage Association plans to pay its outgoing chairman, David O. Maxwell, $27 million in salary and lump sum pension benefits this year. At the same time, Fannie Mae, as the organization is commonly known, has been waging a no–holes–barred lobbying campaign against legislation to subject its three–quarter trillion dollar mortgage operation to private market discipline.

Fannie Mae receives taxpayer subsidies through a series of regulatory exemptions and "implicit" bond guarantees. Its bonds are traded as government securities. Access to cheap credit gives Fannie an unbeatable edge in the multi–trillion dollar secondary mortgage market.

Even before revelations of Maxwell's "golden hand–shake," NTU had advocated capping Fannie's salaries at government levels until the agency was privatized. NTU is planning a "Give it Back, David" campaign, to urge Congress to either privatize Fannie or abolish its Wall Street salary scale. Members interested in participating should call NTU Public Information Director, Pete Sepp. According to Sepp, "it's time to kick some Fannie." ■

Learn How to be a Citizen Lobbyist

Have you ever wanted to make a difference in the debate over a public policy issue, but never found an effective way to express yourself?

NTU will sponsor Citizen Lobbyist Day next September, offering workshop training on how to play the role of lobbyist. Taxpayer–related issue briefings will be held, along with a reception on Capitol Hill. One day will be set aside for actual lobbying, putting into practice what you have learned, accompanied by NTU's team of professional lobbyists.

"We can't do our job effectively without the direct involvement of our members," says Jill Lancelot, NTU's Director of Congressional Affairs and organizer of the event. "It's an opportunity for each of you to learn how to make a difference in our nation's future."

NTU is here in Washington, D.C. where the action is, but it's YOU, the taxpayer, voter and constituent whose voice really matters in the halls of Congress. Write us with your thoughts on how we can make this event an educational experience that will translate into a more forceful voice for the interest of taxpayers. ■

Dollars&Sense

Future Taxpayer Bailouts Guaranteed

Congress Flunks Bank Reform Test

In a display of shortsightedness and self–interest, the U.S. House of Representatives twice rejected bank reform plans on November 5 and November 14.

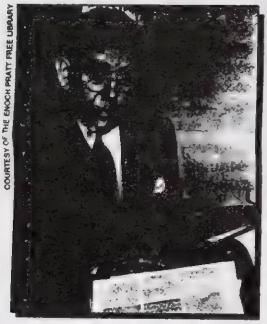
NTU Chairman Jim Davidson was angered by the votes. "The proposals had few protections against future bailouts—but even those weak proposals were too much for the House. It seems likely that Congress will pass a 'narrow bill' without real reforms to our deposit insurance system. If so, Congress will have failed to make the tough choices necessary to address the problem rather than the symptoms. Taxpayers need protection from future bank bailouts. What they are getting is a multi–billion–dollar invoice."

Congress needs to inject funds to the ailing Bank Insurance Fund, which is used to pay off depositors of failed banks. It represents just the first installment payment on a huge liability. The proposed legislation also provided $40 billion in funds to allow the FDIC to pay depositors immediately upon a bank failure, supposedly to be repaid when the agency sells failed bank assets. In mid–November members still faced a vote on an $80 billion bailout of failed S&L's by the Resolution Trust Corporation.

The National Taxpayers Union will continue to work for adoption of meaningful reforms of the deposit insurance system. According to Davidson "our campaign will not end until Congress addresses fundamental deposit insurance problems. Taxpayers at the grassroots must convince their legislators that bank reform issues go beyond special interests and directly affect their wallets." ■

Worth Quoting

"... it would probably help if the operation of banks were confined to men of reasonable training in banks and their ownership to men of substantial financial responsibility. Under our present laws, [anyone] is free to set up a bank and anyone is free to own stock in it. The Federal Insurance scheme has worked up to now simply because there have been very few bank failures. The next time we have a pestilence of them it will come to grief quickly enough, and if the good banks escape ruin with the bad ones it will be only because the taxpayer foots the bill." ■



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— Excerpted from a 1936 column by H. L. Mencken.
Source: *The Impossible H.L. Mencken*
Marion Elizabeth Rodgers, Ed., Doubleday, 1991

Fannie Mae/Freddie Mac:

Unwelcome Guests of the Taxpayer

Ignorance Isn't always bliss for the taxpayers, especially when it comes to Government Sponsored Enterprises (GSE's). These quasi–government financial institutions, which go by more familiar names like Fannie Mae and Freddie Mac, purchase or guarantee loans made by banks and thrifts for mortgages, education, and farms. In fact, GSE's account for nearly $1 trillion in lending—and all of it is implicitly guaranteed by the taxpayer.

Despite this huge loan portfolio, GSE's do not have to live under most of the regulations on private lenders, like capital standards and disclosure requirements. Recent experience proves those standards aren't enough to protect taxpayers. Given the instability of the economy, regulators might not have sufficient warning to prevent a massive taxpayer bailout.

Fortunately, the National Taxpayers Union is leading the fight on Capitol Hill to subject GSE's to the same rules and regulations as their competition. The reform package would include a higher level of operating capital to cushion downturns as well as institute registration of GSE stock with the Securities and Exchange Commission, thereby giving regulators a better accounting of assets and liabilities. ■

Dollars & Sense

Fannie Mae: A Fiscal Crisis?

She's the biggest of her kind around. She regularly intimidates Congress, which sometimes lets her write her own contracts. If you're a taxpayer, she's got you by the purse strings, and it's time you knew her name.

Fannie Mae is a Government Sponsored Enterprise (GSE), a stockholder–owned corporation that purchases home mortgages for banks and thrifts. Together with its smaller brother, Freddie Mac, it has used an implied credit guarantee from Uncle Sam to accumulate more than $1 trillion in securities.

As their main competitors—the savings and loan industry—declined in numbers over the past five years, Fannie Mae and Freddie Mac have nearly tripled in size. They did so in part by taking advantage of an array of tax benefits, regulatory breaks, and securities law exemptions granted by Congress, but otherwise unavailable to banks and thrifts. In the past, that's meant a bonanza of up to 30 percent on equity for some of Fannie Mae's stockholders.

This gravy train rolls along by exposing taxpayers to ever greater dangers. For years the National Taxpayers Union has recommended reforms to force Fannie Mae, Freddie Mac, and other GSE's to adopt adequate capital standards. Fannie Mae and Freddie Mac have gotten by with a capital to asset ratio of as low as one percent, far too low a cushion to protect taxpayers. A safer figure would be four percent or more, or the same standard applied to banks and savings and loans.

PHOTO BY MIKE MINGS

The palace that taxpayers helped build — *The sprawling Washington, D.C. headquarters of the Federal National Mortgage Association (Fannie Mae) seems to resemble the scope of taxpayer guarantees for Fannie Mae's loans—both are difficult to capture in a single snapshot.*

In the last Congress both chambers failed to strengthen regulatory protections or meaningfully increase capital standards. Lobbyists for the two enterprises actually wrote key provisions of the banking legislation that passed overwhelmingly in the House.

Meanwhile, Fannie Mae remains the only federally–created enterprise with a political action committee, which has donated hundreds of thousands of dollars to members of Congress. Now Fannie Mae wants to expand its operations beyond home mortgages into home–equity lending and mortgage insurance.

NTU and NTUF's February 1991 Conference on the financial system brought together top experts from the industry to put together a blueprint for reforming GSE's and heading off the creeping federalization of the credit markets. This year, NTU will push hard for these reforms. For instance, why not take away the special privileges granted GSE's by Congress, and let them compete on an equal footing in the marketplace? At the very least, more strict capital requirements must be adopted to help insulate beleaguered taxpayers from any possible financial meltdown. ■

NICE WORK IF YOU CAN GET IT

In January 1992, outgoing Fannie Mae Chairman David Maxwell was offered $27 million in salary and lump sum pension payments as a "retirement package." Thanks in part to NTU's exposure, Maxwell returned $5 million of his benefits.

But even before this scandal broke, NTU had advocated capping salaries for employees of Government Sponsored Enterprises (GSE's) to the same pay levels of other government personnel until GSE's like Fannie Mae are privatized. "Fannie Mae can't have it both ways," said NTU Executive Vice President David Keating. "If Fannie Mae wants to have a Wall Street salary scale, let it compete in the free market without an implicit credit guarantee from taxpayers." ■

On the Future of the GSEs
Fannie Mae and Freddie Mac

Testimony of
Fred L. Smith, Jr.
President
Competitive Enterprise Institute

before the Capital Markets Subcommittee
of the U.S. House of Representatives
regarding H.R. 3703, the Housing Finance
Regulatory Improvement Act

Thursday, June 15, 2000

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INTRODUCTION

My name is Fred Smith. I head the Competitive Enterprise Institute, a pro-market public policy group. CEI has focused for many years on the ***moral hazard*** problem which is the topic before this Committee. Clearly Fannie Mae and Freddie Mac were created for "good" purposes – now the issue is whether the special privileges they've been granted, specifically their implicit government "insurance" policy, act to distort and destabilize the marketplace.

CEI has been active in examining such moral hazard concerns over the last 16 years. We have long been critical of corporate welfare. We have done extensive work on the comparative value of private as opposed to political insurance, questioned the ability of the IMF to act as "credit doctor" to the sick economies of the world, and criticized the capability of OPIC to better address the risks of overseas investment. Perhaps most relevant to the issue today, we were very active in the policy debates surrounding the S&L deposit insurance crisis of the 1980s.

As others have noted, there is a disturbing similarity between the confused mix of explicit (to the smaller depositor) and implicit (to all depositors and, in effect, to the S&L itself) guarantees available to the S&Ls under the deposit insurance program, and the similar explicit and implicit taxpayer guarantees to Fannie Mae and Freddie Mac (and indeed the other GSEs) which arise from their partially private/partially political nature.

This Committee is asking the right questions. It may indeed be the case that these subsidies are warranted. If so, then let us bring these agencies into a normal reporting relationship with the executive branch (possibly within Treasury) and have the appropriate oversight committees in Congress decide their powers, budget, operating authority and compensation schedules. There should be no subsidies to private parties without holding these parties accountable to the elected representatives of the people: *No subsidies without representation*!

On the other hand, if these subsidies are not warranted, then let us eliminate them and privatize these entities as expeditiously as possible. What I would hope this Committee will not do is to perpetuate the mixed status these organizations now enjoy. To paraphrase William Shakespeare: Fannie Mae and Freddie Mac are neither private "fish" nor political "fowl." No one knows how to evaluate them – it is time to end this confusion.

Privatizing the profit side of the ledger while socializing the loss side is a sure-fire recipe for disaster. It was exactly that problem that so exacerbated the plight of the S&Ls in the 1980s. The smartest investors in the world found it highly rational to invest in some of the worst managed thrifts. These investors realized that the high interest rates offered by these failing institutions *did not* entail any excessive risk. Indeed, they entailed almost no risk at all, since the guarantor of these investments was not the individual S&L, but rather the U.S. government (and thus the U.S. taxpayer). Of course, investors had to exercise due diligence – you had to be careful to ensure that you placed your deposits in a "safe" failing S&L (one that was *Too Big To Fail*) rather than an "unsafe" failing S&L (that is one that was *Too Small To Save*).

And, of course, you had to move faster than the regulators and pull your money out before they actually got around to closing down the institution. But that wasn't difficult. The result?

Sophisticated investors profited massively. Hundreds of billions of capital dollars flowed from well-managed parts of the economy into poorly managed S&Ls. From 1981 to 1984, S&L assets ballooned from $600 billion to around $1200 billion, during a time when this industry was failing badly. Almost all of those assets flowed into the bankrupt part of the industry and, not surprisingly, most of those assets were also badly invested by the S&Ls.

The costs of that misallocation of capital were borne by the taxpayers directly, but the costs also included the waste of misallocated resources, evidenced by empty office buildings and abandoned housing developments in many American cities. The costs were not only in the S&L sector; prudent investors in insurance and other sectors of the economy who operated without government subsidies found that their investments were no longer profitable because of S&L over-investment. Business cycles are painful enough without the additional instabilities created by such subsidy-induced market distortions.

BASIC PRINCIPLES

In assessing the wisdom of the confused private/political nature of these institutions, keep in mind that the basic task of a market economy is *to allocate capital*. The entrepreneur is responsible for considering the available array of returns and risks, and then selecting investments which are most likely to yield the "best" return. The possibility of both profit and loss provides the discipline for the entrepreneur to choose the best use for capital based on consumers' demand – to become more knowledgeable, to explore possible technological and institutional innovations, to improve investment skills over time.

In the American free enterprise system, we entrust the entrepreneur with this critical task. She gains profits (sometimes very large profits) if she is right; she loses (sometimes sharply) if she is wrong. The entrepreneur's risk management skills—in selecting those individuals who receive loans, in supervising the lending operation, in diversifying the loan portfolio—together with uncontrollable circumstances, determine success or failure. The unhampered market is the most effective way to encourage such vital entrepreneurial activity.

The moral hazard problem arises when we bail out investors when things go wrong, when we move toward a "profit-side capitalism/ loss-side socialism" strategy. This is what happened in the S&L crisis and the costs were massive. "Moral hazard" is always a risk when an activity is insured – but the private sector is far better at policing such induced risk. When it's your money at stake, you're more careful. Political money managers faces weaker market disciplines: if they fail, they only share in the loss. Government risk subsidies anaesthetize our sensitivity to risk. As Treasury Undersecretary Gary Gensler noted: "Promoting market discipline means crafting government policy so that creditors do not rely on governmental intervention to safeguard them against loss."

Determining the seriousness of the risks that America faces because of the guarantees granted GSEs is not an easy task. However, we do know that the current system resembles that of the S&Ls . The moral hazard risks associated with government guarantees have not gone away; indeed, one might argue that they have now been *concentrated* in Fannie Mae and Freddie Mac.

Testimony of Fred L. Smith, Jr., HR 3703, June 15, 2000.

These institutions hold a much larger portfolio of housing-related financial instruments (and a more concentrated form of assets) than did any S&L in days past. A systemic downturn in the housing market may lead them into increasingly risky lending practices as it did the S&Ls in years past.

Indeed, the rapid growth of these agencies over the last decade and the rational (or perhaps not-so-rational) exuberance that has caused their stock values to appreciate so rapidly is indicative of a heady expectation that they represent a low-risk investment to investors – if not to society. Certainly, much has been made of the skill of Fannie and Freddie in creating a secondary market in home mortgages and, undoubtedly, they merit some applause here.

However, while the risk of a packaged portfolio of risky loans can be lower than the risks of the loans on an individual basis, the risk of such a portfolio can also be *higher*. How well have Fannie and Freddie packaged such loans? If these were private firms, one could be reasonably sure that the purchasers had checked all this out – they would be the ones who would lose if the packaging was careless, after all. Given the implicit guarantees enjoyed by Fannie and Freddie, is anyone really ensuring that all of these factors have been taken into account? Markets are very effective regulators, but Fannie/Freddie operate only partially in the free market.

The fact is that, we can never be totally sure of the safety or insecurity of the GSE system. Still, the S&L crisis is a very good moral lesson. Most S&Ls were well run by fiscally responsible individuals. It was only when the system got into trouble that older managers began throwing "Hail Mary" passes, and newer go-go managers were attracted to the scene. The situation moved from tranquility to chaos in a very short period of time; reasonable losses became catastrophic in only a few years. The problem was manageable until it became intractable.

That's the problem with Fannie Mae and Freddie Mac. It isn't raining yet – and Franklin Raines seems like a pretty good manager. What will all of this look like if the economy turns sour, if many of these over-extended new homeowners begin to default? What will happen to Fannie Mae if it becomes less attractive to investors? Furthermore, is the move of the GSEs into newer lending areas – necessary if they are to continue their rapid growth – really wise? Is it really fair to enterprises who do not enjoy these agencies' special privileges?

Now is an ideal time to address this problem. The major GSEs seem healthy; stock values seem upwardly less volatile than in years past (therefore, one might anticipate that current values reflect less of an expectation of super growth in coming years). The economy at this time is still robust and the managers of these institutions seem confident of their competency and the soundness of their institutions. Indeed, they seem proud of their ability to manage risk. Good – then let's quickly eliminate the features that now weaken the market disciplines facing them and their customers.

Too often, Congress does nothing when things seem to be going well – and then finds itself unable to take disciplinary action when the crisis occurs. At that late point in the process, the pain would be too great and the political resistance too strong. When it's not raining, the roof isn't leaking – when it's raining, it's too difficult to fix it. Surely we can do better, and you, Mr.

Chairman and this Committee, deserve full credit for your foresight in addressing this problem at a time when corrective action can be taken at relatively low cost.

Of course, you will have opposition to any effort to wean the Fannie Maes of the world away from their federal subsidies. My casual observation suggests you may face even more opposition from the newspapers and Fannie Mae's ad agencies. (I've never seen a private firm spending so much on such "public service" ads.)

HAVE FREDDIE AND FANNIE OUTLIVED THEIR USEFULNESS?

To ask this question is to risk heresy, as the reader of today's (6/14/00) *Washington Post* can quickly ascertain. Absent these building blocks of the Great Society, American home ownership would be curtailed, mortgage rates would soar, the terms of our mortgages would be far less favorable, and, they seem to say, we'd all be far worse off. Indeed, these ads suggest that the secondary markets in mortgages would somehow disappear without Freddie and Fannie.

Moreover, they argue that their chartered privileges aren't really relevant to the institutions themselves. They seem to suggest that Fannie and Freddie would exist pretty similarly in a purely private setting. However, the costs of housing would go up. They note that even if one accepts the $6.5 billion per year subsidy level estimated way back in 1995 (at a time when these institutions were much smaller), that at least two/thirds of that subsidy is passed along to consumers in the form of lower interest rates.

Still, they obviously do receive and enjoy these special privileges – why else would they be lobbying so aggressively not to have them taken away? In part, I suppose, this must reflect the salary levels of this organization which are certainly more generous than those typical in the political side of the coin. (Raines' salary alone would probably finance the top echelon of the Treasury.) There's nothing wrong with high salaries, of course, but one wonders whether these would be available absent the special treatment. (All this recalls the story about the missionaries to Hawaii who came to do good and did very well indeed! There's a lot of money in public service – at least at Freddie and Fannie.)

In preparing for this testimony, I was amused at the number of stock analysts who called to ask me whether I thought that GSE reform was even remotely likely. They couched their remarks in questioning tones: "Well, why are you opposed to GSEs?" When I suggested the case outlined above, they pressed me to be more explicit. When I asked why they cared, they explained that they rate Fannie and Freddie. So I asked if they would change the ratings if the agencies' special privileges were removed. "Sure," they responded – and, of course, that's what's going on here. If a reasonable lobbying effort can retain these privileges, then Fannie Mae and Freddie Mac will have lower costs of business and be able to quash their competitors. It's good for them – but not so good for the American taxpayer or for competing financial institutions in the free market.

After all, would the ending of these institutions special status really create any serious problems? Perhaps, but I doubt it. After all, these institutions were created at a period when federal and state financial service regulations blocked the geographic diversification necessary for stabilizing

loan markets, for arbitraging to smooth out the roughness that made loan rates so variable around the nation. It was not that markets failed or that entrepreneurs weren't innovative -- but rather that markets were crippled, handicapped by excessive regulation.

The innovations that the GSEs have so benefited from today – the packaging of securities so as to reduce the overall risk of the portfolio and the subsequent securitization of that portfolio both to diversify risk and to expand the market for such risks – were pioneered, after all, outside the Freddie/Fannie world by Michael Milken and others. Secondary markets would exist regardless of what this committee may elect to do.

Fannie and Freddie were granted special privileges in their charters. They are exempt from SEC registration (an exemption estimated to save them hundreds of millions annually) and from state and local taxes (another "savings" in the hundreds of millions – and one that is especially troubling here in the District of Columbia). Banking rules allow their securities to be held in unlimited amounts by banks and other deposit-insured institutions (based on the presumption that they are somehow "riskless" securities). They were also granted an explicit line of credit from the Treasury. Most importantly, there is a widespread presumption that in the event of problems, the full faith and credit of the U.S. government will be called upon – that Fannie/Freddie are *Too Big To Fail!*

As I note below, HR 3703 calls all of these exemptions into question. Indeed, in today's world, deregulation, technological and institutional innovation, and globalization have eliminated whatever original rationale may have existed for the special privileges these entities still retain. There is already a robust market for securitizing a range of securities – entrepreneurial investment bonds, consumer loans (including auto, boat and home improvement loans), accounts receivables. Indeed, the move by Fannie and Freddie into the second mortgage/home equity loan area threatens these now private-sector areas. After all, a "home equity" loan can be used for anything – Fannie Mae may well be financing jacuzzis. How would they know?

To date, there has been too little thought given to eliminating these anomalous creations. Indeed, these institutions have taken advantage of their special privileges to grow rapidly. They now control vastly more resources than do individual thrifts or most banks. Indeed, if current trends continue, their indebtedness will exceed that of the U.S. Treasury within the next few years. America has spent much energy in working its way out of the massive federal debt that we accumulated over the last century –a public debt that was explicit and highly visible, and thus. clearly accountable to the American taxpayer. We are now at risk of building debt that would be largely invisible to the checks and balances of our political process, a debt that would be hidden behind the implicit guarantees enjoyed by Fannie and Freddie.

Mortgage rates might go up somewhat should these agencies' special privileges be taken away, but that's happened for the last several years and it hasn't created any noticeable problem in housing markets. Most of the benefits of these programs go to people who would buy or refinance in any event – mostly to middle and upper income beneficiaries. Fannie and Freddie certainly are not in the business of alleviating poverty. They pay some healthy fees to gain local good will, but that is public relations (not economics or welfare). There would be some very good aspects of ending all this. Any market gains by Fannie or Freddie would reflect their

superior abilities rather than their special status. There would be no crowding out of current firms providing creative services in the consumer credit and insurance fields. If these agencies are out-competed, so be it.

We should realize that the capital that is attracted to the housing markets by Fannie and Freddie doesn't come out of thin air: it is diverted from other possible end uses in the market. These uses include the financing of small businesses, technological startups, municipal and state programs, and foreign investments. Artificial shifts of capital into the housing market, of course, benefit somewhat those now purchasing homes, yet it disadvantages all of the above groups. Whether, on net, these loses are offset by the potential gains of additional home ownership is unclear. Would America be better with a marginally smaller home ownership ratio but a somewhat higher marginal rate of successful small business start ups?

The Inherent Unfairness of Fannie and Freddie

Other panel members will address the proposition that these agencies are anti-poverty programs – that they are a means of providing "affordable" housing to low-income and minority consumers. Housing subsidies raise the price of housing – this is a well-known phenomena that reduces the desired impact of most subsidies. As noted above, much of the estimated subsidy (about one-third according to a CBO study) benefits the management and the shareholders of these private firms.

Can anyone imagine Congress approving a $2 billion plus appropriation bill to benefit the management and shareholders of any other private sector firm? The wording of the CBO study was colorful: "As a means of funneling federal subsidies to home buyers, therefore, the GSEs are a spongy conduit – soaking up nearly $1 for every $2 delivered." For that matter, can one imagine an honest debate about the merits of authorizing $4 billion to reduce home ownership costs for middle- and upper- income Americans?

Moreover, while home ownership is a "good thing," so also are other values that may well be harmed by the Fannie/Freddie distortions. Luring undercapitalized individuals into debts beyond their ability to repay does them no favor. Society must tread a very narrow path between pricing the poor out of the market, and exposing them to excessive financial risk. Moreover, the major problems with affordable housing are not borrowing costs, but rather regulatory costs, which fall outside the purview of Fannie and Freddie. Determining the level of debt that can reasonably be handled by people of varying incomes has been one of America's greatest achievements (made possibly by the creative use of credit information). Freddie and Fannie seem to do this very well – but they hold no exclusive rights to this technology.

The features of your bill are positive and some may improve the current situation. I comment on them now:

- A Revised Board: This might be useful; but Fannie and Freddie will still be able to run circles around regulators. Market regulation is the only way to discipline markets.

- More Frequent Reviews/ Approval of New Lines of Business: This may be necessary given the liability that allowing these groups to enter new lines of business would entail. However, bureaucrats will not find it easy to determine whether allowing Fannie and Freddie into new lines of business will be a good idea or not. Recall that Franklin Raines himself criticized the S&L regulators for allowing those institutions to move outside the traditional mortgage field during their crisis.

  Yet, studies of how S&Ls used those expanded powers found that failure rates were not associated with the use or non-use of these expanded line-of-business freedoms. That is, an S&L that stayed within its traditional line of business was as likely, but not more likely, to fail than one that went into non-traditional fields. Fixed-rate long-term securities are not a risk free investment area, after all. The concern here is real – why should subsidized firms be able to compete with private tax-paying firms? Still, the solution is probably not to second guess Fannie and Freddie but rather to privatize them.

- Similarly, the goal of assessing the riskiness of the various elements in the capital reserves of these entities is worthwhile but not easily undertaken by bureaucrats. Capital is a fluid term and many of the newer financial instruments may more adequately protect the security of a firm than traditional securities.

- Repeal the Freddie and Fannie Line of Credit: This is an excellent idea but how can one make that repeal credible? The current size of these institutions argues against any realistic attempt to give them a "haircut." What might be done? It is a good idea but the question is how to make that repeal credible. Politicians weren't even willing to let a large S&L collapse during that crisis.

  I suggest that we consider using the skills of Jamie Gorelick to address this problem. In the study contemplated by this Committee, we might well have her design an appropriate privatization/divestiture plan. Fannie could readily be broken up into two or four national diversified firms, and cut loose from federal subsidies. Ms. Gorelick's experience at DOJ suggests that carving up "too large" corporations is a skill that she has acquired. Why not put it to good use?

- Receivership status: It is always a good idea to plan for a possible disaster before it occurs. Developing a procedure for handling the possible failure of GSEs is a good idea.

- Standardizing the Regulatory and Tax Treatment of Fannie and Freddie: In general, I find these reforms reasonable; however, one must question whether the current SEC rules are rational and thus whether expanding their ambit is a good thing.

- Study – a good idea but I would broaden the study. I would suggest several other issues:
    - Examine the incentives that might face the Freddie/Fannie management if a severe crisis occurs. The S&L crisis triggered behavior that was very different from that characteristic of the industry in calmer times; moreover the leadership attracted to the S&L sector was very different than the cautious blandness of earlier days. Could this also be true of the GSEs?
    - Conduct a distributional analysis of who actually benefits from these programs – how are the interest savings distributed by income groups.
    - A comparative analysis of other secondary markets – "junk" bonds, accounts receivable, auto loans – how did these markets arise, how well do they perform vis a vis the secondary home mortgage markets.
    - A comparative analysis of housing markets in other nations. How do the differential patterns in the housing markets track the differential patterns in consumer markets more generally. Europe, for example, has less friendly housing markets but also less friendly consumer credit markets. What factors account for these differences? How much (if any) credit should go to Freddie and Fannie for our more consumer friendly housing market?

Let me end with a comment on the overall wisdom of the whole concept of Government Sponsored Enterprises. Isn't this oxymoronic? At best, this mixing of private and political incentives creates marketplace confusion; at worst, it leads to a serious misallocation of capital and an increasing risk for American taxpayers. George Orwell noted that in the political world, words can be linked together to suggest almost anything. His writings also suggest that the results of that process are destructive.

Again, I commend this Committee for raising the issue of the appropriateness of GSEs generally and the Fannie/Freddie pair in particular. Change in this area will come slowly, but the first step is opening up the door and letting in fresh air. These hearings are doing that, and from my readings of earlier witnesses, doing it well.

Nationalizing Mortgage Risk

The Growth of Fannie Mae and Freddie Mac

Peter J. Wallison and Bert Ely

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1
Introduction

Fannie Mae and Freddie Mac are today the largest financial institutions in the United States. Many economic studies, including one by the Congressional Budget Office (CBO), have concluded that these government-sponsored enterprises (GSEs) receive an implicit government subsidy arising out of the statutory benefits they retained at the time they were "privatized" (Fannie in 1970, Freddie in the 1980s). In 1996, the CBO estimated the value of that subsidy at $6.5 billion for the previous year, and the subsidy has grown substantially larger since then.

According to the CBO, only a portion of that subsidy is actually passed along to the mortgage markets.[1] The balance, almost a third, is retained for the shareholders and managements of the two companies, accounting for more than 40 percent of their 1995 profits (which ranked them among the most profitable publicly held companies in the United States).

The lower interest rates that Fannie and Freddie can command because of their government backing permit them to out-compete any private-sector rival and to dominate any market they are permitted to enter. Although their charters are supposed to limit their activities—preventing them from competing with companies that must raise their funds without government backing—the vagueness of the charters and the political power of Fannie and Freddie have enabled them to expand with few constraints. That they can and do make soft-money political contributions, hire legions of

lobbyists, and employ people with close ties to Congress as top management further ensures their insulation from scrutiny.

Meanwhile, their dominance of the residential mortgage markets grows ever greater. Reasonable projections based on statements by Franklin Raines, the chairman of Fannie Mae, suggest that, by the end of 2003, the two companies will have assumed the risk associated with almost *half* of all the residential mortgages in the United States. That means that the taxpayers, who ultimately stand behind the obligations of these two companies, will have unwittingly become responsible for almost *$3 trillion* of residential mortgage risk that should be on the books of private-sector firms.

An important decision point lies immediately ahead. As shown in this analysis, in four years, Fannie and Freddie will have either acquired for their portfolios or guaranteed more than 91 percent of all the conventional/conforming mortgages in the United States. Those are the high-quality loans on middle-class homes that have until now been virtually the only mortgages the GSEs would purchase. As they grow beyond their traditional market segment, Fannie and Freddie will have to purchase increasing amounts of lower-quality loans and hold more of those loans in portfolio, increasing their risks. If they fully hedge those risks, their extraordinary profitability will decline.

The question is whether Fannie and Freddie will (1) slow their growth to reduce the risks they take on; (2) continue their growth at the rate Franklin Raines predicted, but accept reduced profitability by hedging those risks; or (3) continue the growth in both those assets and risks in order to achieve high profitability. The evidence is that they are pursuing the third course.

To be sure, there is nothing wrong with growth, risk, or profitability. But the growth of the GSEs—aided as it is by government support—creates enor-

mous risks for taxpayers only a decade after the savings and loan bailout, and it threatens to drive a whole sector of the private financial community out of the residential mortgage market. Those factors raise serious policy issues. The purpose of this study is to examine the implications of that growth for the mortgage market, for those who compete with Fannie and Freddie, and for the nation's taxpayers.

Chapter 2 provides background on the GSEs and the mortgage markets. It outlines the statutory links to the federal government that have led the financial markets to conclude that Fannie and Freddie will not be allowed to fail, describes the mortgage market in the United States, and summarizes both the functions and growth of the GSEs.

Chapter 3 contains detailed information on the structure of the residential mortgage market today, the growth of Fannie and Freddie's share of that market since 1995, and (if the forecasts of Fannie's chairman are correct) the share they will hold—together and separately—at the end of 2003. It shows that the GSEs' total risk—including both the mortgages they will own and those they have guaranteed—will increase from somewhat more than a third of the market today to almost half of a much larger market four years hence.

The growth of Fannie and Freddie in relation to the growth of the conventional/conforming sector of the market is examined in chapter 4. It shows that, beginning in 1998, they were already acquiring more net mortgage assets in each year than the total net principal amount of the conventional/conforming loans made in that year. The data presented in chapter 4 also show that, by the end of 1998, Fannie and Freddie were holding in portfolio or had guaranteed more than 73 percent of all conventional/conforming mortgages, and that that figure could reach almost 92 percent by 2003.

The implications of that growth are addressed in chapter 5, which discusses the possibility that—to make

up for the absence of sufficient conventional/conforming mortgages—Fannie and Freddie will have to drive deeper into the subprime markets, taking more risk and displacing more of the genuine private-sector lenders who have traditionally made these loans. The chapter also discusses other financial services that Fannie and Freddie might be preparing to offer if their charters are not more strictly interpreted.

Chapter 6 continues the analysis of the implications of GSE growth, focusing on the risks to taxpayers that will be associated with the nationalization of almost half the residential mortgage market by 2003. The chapter points out that Fannie and Freddie have a choice—to hedge the greater risks they will be taking and reduce their profitability, or to maintain their level of profit growth by taking greater risk. It suggests that the incentives of management and the pressures of the financial markets will push the two GSEs toward greater risk-taking.

The study's conclusion notes that there is an inherent conflict between the GSEs' status as private, profit-making companies and the government mission they are expected to perform. There is ample evidence that their government mission is no longer necessary, and that they are using the subsidy they receive primarily to enhance their profitability and to dominate their market. Even if that were not true, the risks they are creating for taxpayers and the threat they represent to nonsubsidized private-sector competitors would argue strongly for more strictly confining them to limited areas of activity, eliminating their links to the government, or taking steps toward recapturing their subsidy through a complete privatization.

2
Background

The Federal National Mortgage Association (popularly known as Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) are two government-chartered and government-sponsored corporations that have been assigned the statutory mission of improving liquidity in the middle-class residential mortgage markets by buying and selling residential mortgages.

Fannie Mae and Freddie Mac carry on their functions in two ways—by purchasing and holding mortgages originated by mortgage lenders, and by placing their guarantee on securities (mortgage-backed securities, or MBSs) that represent an interest in pools of mortgages they have assembled. Whether they are holding mortgage loans or MBSs in their portfolio or are guaranteeing MBSs that are then sold to investors, they are assuming the credit risk associated with those loans.

Although initially established to enhance liquidity in the mortgage markets, it is doubtful that Fannie and Freddie are necessary for that purpose today. Many private organizations are now capable of purchasing mortgages from originators and selling them—either directly or through securitization—into the capital markets. However, Fannie and Freddie now argue that they perform their public mission by reducing interest rates on the mortgages they are permitted to buy, and thus help homebuyers to obtain lower-cost financing. That claim is dubious; economists believe that the

lower rates attributable to the GSEs' subsidized borrowing are simply capitalized into the cost of the homes, thus benefiting developers and homesellers rather than buyers.

Fannie and Freddie were originally government agencies but were "privatized" when they were permitted to sell shares to the public. Today, both companies are among the largest and most profitable financial institutions in the world, with their securities listed on the New York Stock Exchange.

The unusual thing about their privatization, however, is that Fannie and Freddie continue to retain a large number of connections to the government, as well as various privileges and immunities that no genuinely private company can claim:

- The president appoints up to five members (a minority) of their boards of directors.
- The secretary of the Treasury is authorized to invest up to $2.25 billion in their securities, and to approve their issuance of debt.
- They are exempt from state and local income taxes and from the requirement to register their securities with the Securities and Exchange Commission.
- Their debt securities are eligible for open-market transactions by the Federal Reserve Board and for investment by insured banks.
- Their debt securities are eligible collateral for the federal government's deposits of tax revenues in banks.
- Their securities require only a 20 percent risk-weighting (versus 100 percent for the securities and debt of private companies) under the Basel risk-based capital standards applicable to banks.

Those extraordinary advantages have convinced the capital markets that the federal government will never allow Fannie and Freddie to fail. Thus, they are

able to sell their debt securities at interest rates that are consistently better than any AAA-rated corporation in the world and just slightly above the rate paid by the Treasury itself. Moreover, that favored position allows them to operate with capital levels that are much lower than those of other financial intermediaries, since the capital markets are not concerned that those low capital levels will ever mean losses to the holders of their debt or their MBSs.

The Market in Which the GSEs Operate

The residential mortgage market is composed of a number of segments—government-guaranteed Veterans Administration (VA) and Federal Housing Administration (FHA) loans; multifamily housing loans; middle-class mortgages (known as conventional/conforming mortgages, the basic loans that Fannie Mae and Freddie Mac purchase or guarantee); subprime loans (loans with credit deficiencies); home equity loans; and so-called jumbo loans, which exceed the size limit on conventional/conforming loans.

According to Federal Reserve data, FHA and VA loans constitute about 11 percent of the total market. Although similarly authoritative numbers are difficult to obtain for jumbo loans, most observers agree that those mortgages constitute another 15 percent of the market. Fannie and Freddie cannot compete for most FHA and VA loans, since those are purchased and marketed by the Government National Mortgage Association (known as Ginnie Mae), an on-budget government agency that obtains its funds at Treasury rates and thus can offer lower rates than can Fannie and Freddie.[2] Nor can Fannie and Freddie compete for jumbo mortgages, which have initial loan amounts above $252,700, the limit on the size of the loans Fannie and Freddie can purchase in the year 2000.[3]

That leaves 74 percent of the total residential mar-

ket in which Fannie and Freddie can invest. Of that portion, most are conventional/conforming loans; the balance are subprime, home equity, and multifamily housing loans.

In the past, the GSEs purchased almost exclusively conventional/conforming loans, because those are the best credits available in the middle-class market. But increasingly in recent years—as they have foreseen that their need for assets will outstrip the conventional/conforming market—the GSEs have entered the market for subprime, home equity, and multifamily housing loans. Those assets are riskier middle-class credits, since they represent loans to borrowers with impaired credit (subprime loans), subordinated debt (home equity loans), and rental housing (multifamily).

GSE Growth

In a statement to a September 1999 financial conference, Franklin Raines predicted that by the end of 2003 Fannie Mae will have 28 percent of the U.S. residential mortgage market, and that its profitability will have doubled. Raines's forecast implies an 11.3 percent annual rate of growth in risk and a 15 percent annual rate of growth in profitability during 1999 and over the following four years.[4]

The Raines statement provides a valuable benchmark for assessing both the steps that Fannie Mae must take to achieve that goal and the shape of the residential mortgage market in 2003, if the goal has then been achieved.

At the end of 1999, the residential mortgage market—that is, all outstanding residential mortgage loans in the United States—had an aggregate book value of just over $5 trillion. In 1998 and 1999, that market grew strongly—by more than 8 percent each year. But its long-term growth rate has been about 6 percent. If we make the conservative assumption that the residen-

tial mortgage market will grow at that rate for the next four years, it will have a total value of about $6.4 trillion in the year 2003.

Thus, when its chairman predicts that Fannie Mae will have 28 percent of the residential mortgage market in 2003, he is saying that it will in that year have assumed the risk of mortgage loans with an aggregate value of more than $1.8 trillion. At that size, Fannie Mae may or may not be the largest financial institution in the world—depending on the size of future mergers among the world's largest banks—but it will unquestionably be the largest S&L the world has ever seen.

And in second place will be Freddie Mac, which in 1999 was about two-thirds the size of Fannie. If we assume that that relative size differential will continue through 2003, then Freddie Mac will hold in portfolio, or will have guaranteed, mortgages with an aggregate value of more than $1.2 trillion, a growth rate of 11.4 percent between 1998 and 2003.

Together, then, the GSEs in 2003 will be bearing the risk associated with more than $3 trillion in residential mortgages, or almost 48 percent of all home mortgages in the United States. The balance of the market—barely more than half—will be left to the thousands of private, nonsubsidized lenders who have traditionally provided mortgage finance in the United States.

Those extraordinary facts have a number of equally startling corollaries:

- Since the U.S. government stands behind the obligations of the GSEs, the nation's taxpayers—rather than the shareholders of private-sector mortgage lenders—will ultimately bear the risks associated with almost half of all the residential mortgage debt outstanding in the United States.
- If the total residential mortgage market is growing at 6 percent a year, and Fannie and Freddie are

growing, respectively, at 11.3 percent and 11.4 percent a year, then the GSEs cannot achieve their growth goals solely within their traditional segment of the residential mortgage market. They will have to strike out into other areas.

- The current private-sector sources of mortgage finance will be forced to consolidate and will gradually be squeezed out of the residential market; in effect, half of that sector of the economy will have been nationalized.
- Just as ominously, achieving a 15 percent annual rate of profit growth will require that Fannie and Freddie take on and retain more financial risk—in a process reminiscent of the S&L industry's ultimately fatal effort to achieve high levels of profitability only fifteen years ago.

3
Market Shares

Table 3–1 shows the growth of the residential mortgage markets since 1995. The data for the size of the FHA/VA market (line 3), multifamily mortgages (line 5), and the mortgage market as a whole (line 6), during the years 1995 through 1998, are taken from reports published by the Federal Reserve Board. Information on the size of the jumbo market (line 1) and the conventional/conforming market (line 2) was derived from industry sources. Other one-to-four-family mortgages (line 4), a residual figure, consists primarily of subprime and home equity loans. For the purpose of this study, those loans and multifamily loans (loans for apartment buildings) have been combined into a category called "all other."

Assumptions and Data

The projections for 1999 through 2003 are based on our judgment that the very strong residential real estate market during 1998 and 1999 will return gradually over the next four years to its historical pattern. Thus, although the market grew by 9.3 percent in 1998, we project that it will have grown by about 8 percent when all the data on 1999 are in, by 7 percent in 2000, and by 6 percent in each of the three years thereafter.

Historically, total residential real estate mortgage debt has grown slightly faster than nominal gross domestic product (GDP). In that context, residential mortgage debt's extraordinary growth in 1998 cannot

TABLE 3–1
SIZE OF THE RESIDENTIAL MORTGAGE MARKET, PAST, PRESENT, AND PROJECTED, 1995–2003
(dollars, in millions)

		History (Year-End)				Projection (Year-End)					Annual Growth Rate: 1995–1998 (%)	Annual Growth Rate: 1998–2003 (%)	Growth Rate Difference
		1995	1996	1997	1998	1999	2000	2001	2002	2003			
	Composition of outstanding mortgage market												
1	Jumbo mortgages	568,008	602,069	639,797	699,485	755,444	808,325	856,825	908,234	962,728	7.2	6.6	−0.6
2	Conventional/conforming	1,969,096	2,087,172	2,217,961	2,424,882	2,618,873	2,802,194	2,970,326	3,148,545	3,337,458	7.2	6.6	−0.6
3	FHA/VA mortgages	466,620	497,684	525,000	524,354	546,377	566,456	584,300	602,705	621,690	4.0	3.5	−0.5
4	Other 1–4-family mortgages	505,997	532,085	572,096	673,732	747,556	818,051	883,279	952,928	1,027,281	10.0	8.8	−1.2
5	Multifamily: all kinds	277,002	294,783	310,456	340,782	368,045	393,808	417,436	442,482	469,031	7.2	6.6	−0.6
6	Total residential mortgages	3,786,723	4,013,793	4,265,310	4,663,235	5,036,294	5,388,834	5,712,164	6,054,894	6,418,188	7.2	6.6	−0.6
7	Annual growth rate (%)	4.3	6.0	6.3	9.3	8.0	7.0	6.0	6.0	6.0			

SOURCES: For all tables, historic data sources are as follows: *Federal Reserve Bulletin*, December 1999; periodic financial reports issued by Fannie Mae and Freddie Mac; and industry estimates. Projected data are the projections of Peter J. Wallison and Bert Ely.

be expected to continue. If we assume that the market will gradually return to its historic growth pattern in relation to GDP, that would reinforce the projection of a gradual return to a 6 percent growth rate beginning in 2001.

The division of the market into four subcategories—jumbo, conventional/conforming, FHA/VA, and all other (subprime, home equity, and multifamily loans)—is necessarily somewhat arbitrary. There are no official or government estimates of the size of key market segments; apart from FHA/VA and multifamily mortgages, there are no formally recognized and defined subcategories into which the market has been divided for purposes of official reporting.

Although official figures are lacking, there is a wide variety of unofficial market breakdowns.[5] The data we have received from market sources, however, indicate that jumbo loans account for about 15 percent of the market and FHA-VA loans for about 11 percent. Accordingly, conventional/conforming plus all other loans—the loans in which Fannie and Freddie can invest—account for about 74 percent.[6]

Fannie and Freddie Market Shares

Table 3–2 contains data on the respective market shares of Fannie and Freddie. The information on their shares between 1995 and 1998 was derived by comparing the information in their financial statements to known market totals. For the years after 1998, we assumed a growth rate in market shares that would permit Fannie Mae to reach the 28 percent market share projected by Franklin Raines for the year 2003. We then assumed that Freddie's growth rate would be such as to maintain its market share in relation to Fannie. That means that Fannie, which had grown at a rate of 11.2 percent annually between 1995 and 1998 (line 11), would have to grow at a slightly greater rate, 11.3 per-

TABLE 3–2

FANNIE MAE AND FREDDIE MAC MARKET SHARES, PAST, PRESENT, AND PROJECTED, 1995–2003

(dollars, in millions)

		History (Year-End)				*Projection (Year-End)*					*Annual Growth Rate: 1995–1998 (%)*	*Annual Growth Rate: 1998–2003 (%)*	*Growth Rate Difference*
		1995	1996	1997	1998	1999	2000	2001	2002	2003			
	Fannie/Freddie retained portfolios, total mortgages outstanding												
	Fannie Mae:												
8	Retained portfolio:	252,868	286,527	316,592	415,434	528,811	635,882	754,006	877,960	1,020,492	18.0	19.7	1.7
9	Total residential (%)	6.7	7.1	7.4	8.9	10.5	11.8	13.2	14.5	15.9			
10	Conventional/conforming & all other (%)	9.2	9.8	10.2	12.1	14.2	15.8	17.7	19.3	21.1			
11	Retained + guaranteed:	766,098	834,700	895,730	1,052,577	1,208,711	1,347,209	1,485,163	1,634,821	1,797,093	11.2	11.3	0.1
12	Total residential (%)	20.2	20.8	20.9	22.5	24.0	25.0	26.0	27.0	28.0			
13	Conventional/conforming & all other (%)	27.8	28.6	28.9	30.6	32.4	33.6	34.8	36.0	37.2			

	Freddie Mac:												
14	Retained portfolio:	107,706	137,826	164,543	255,670	337,432	420,329	506,383	605,489	712,419	33.4	22.7	−10.7
15	Total residential (%)	2.8	3.4	3.8	5.5	6.7	7.8	8.9	10.0	11.1			
16	Conventional/conforming & all other (%)	3.9	4.7	5.3	7.4	9.0	10.5	11.9	13.3	14.7			
17	Retained + guaranteed:	566,751	610,891	640,528	734,021	846,097	943,046	1,039,614	1,144,375	1,257,965	9.0	11.4	2.4
18	Total residential (%)	15.0	15.2	15.0	15.7	16.8	17.5	18.2	18.9	19.6			
19	Conventional/conforming & all other (%)	20.6	21.0	20.7	21.3	22.7	23.5	24.3	25.2	26.0			
	Fannie + Freddie:												
20	Retained portfolio:	360,574	424,353	481,135	671,104	866,243	1,056,212	1,262,388	1,483,449	1,732,911	23.0	20.9	−2.1
21	Total residential (%)	9.5	10.6	11.2	14.3	17.2	19.6	22.1	24.5	27.0			
22	Conventional/conforming & all other (%)	13.1	14.6	15.5	19.5	23.2	26.3	29.6	32.6	35.9			
23	Retained + guaranteed:	1,332,849	1,445,591	1,536,258	1,786,598	2,054,808	2,290,255	2,524,777	2,779,196	3,055,057	10.3	11.3	1.1
24	Total residential (%)	35.2	35.9	35.9	38.2	40.8	42.5	44.2	45.9	47.6			
25	Conventional/conforming & all other (%)	48.4	49.6	49.5	51.9	55.0	57.1	59.1	61.2	63.2			
26	Conventional/conforming only (%)	67.7	69.3	69.3	73.7	78.5	81.7	85.0	88.3	91.5			

cent, from 1999 through 2003, and that Freddie would have to increase its growth rate from 9 percent to 11.4 percent (line 17).

Table 3–2 displays market share data in two ways: (1) the respective mortgage portfolios of Fannie and Freddie as a percentage of the market as a whole, and (2) those mortgage portfolios plus the principal amount of the mortgage-backed securities that Fannie and Freddie have guaranteed—again, as a percentage of the market as a whole. We show those data separately for two reasons.

First, while there is no significant difference between the credit risk of guaranteeing MBSs and the risk of holding whole mortgages, there is a substantial difference in profitability. Fannie and Freddie earn considerably more from retaining mortgages in their portfolios than from receiving guarantee fees on MBSs. That is because they assume an additional risk—interest-rate risk—when they retain mortgages. Accordingly, as Fannie strives to meet Franklin Raines's forecast of 15 percent annual profitability growth, we would expect to see greater proportional growth in its mortgage portfolio than in its guarantees of MBSs.[7] That differential is reflected in our projections.

Indeed, just such a trend is visible between 1995 and 1998, when Fannie's mortgage portfolio grew by 18 percent (line 8), while its total risk (mortgages plus MBSs it had guaranteed) increased by only 11.2 percent (line 11). We believe that trend will continue and will become more pronounced from 1999 to 2003, with Fannie's portfolio of mortgages increasing by 19.7 percent on an annualized basis during that period.

We project a different trend for Freddie, which (starting at a much lower base than Fannie) grew its portfolio at the unsustainable rate of 33.4 percent annually between 1995 and 1998. Since we are assuming that for 1999 and the next four years Freddie will remain about two-thirds the size of Fannie, we are pro-

jecting that Freddie will reduce the rate of growth of its retained mortgage portfolio to 22.7 percent (line 14)—a rate that will still be higher than Fannie's but will bring Freddie in 2003 to a position at which its retained mortgage portfolio will be roughly 70 percent the size of Fannie's.

Second, making a distinction between mortgages retained in portfolio and mortgages guaranteed through MBSs reveals that Fannie and Freddie have only a limited range of options available to them. When Franklin Raines predicted that Fannie Mae would reach 28 percent of the total residential mortgage market in 2003 (line 12), he could have been referring to substantial growth in Fannie's issuance of MBSs, with much lower growth in the company's mortgage portfolio. However, when he forecast that Fannie would double its profitability during that period, he could only have been talking about a substantial increase in Fannie's mortgage portfolio, since only by enlarging that portfolio can a 28 percent market share be consistent with a 15 percent year-over-year rate of profit growth.

Fannie's options are further limited by the fact that the GSEs are permitted to purchase or guarantee only those mortgages with an initial principal amount that (in 2000) does not exceed $252,700. As noted above, that limitation essentially confines them to 74 percent of the total residential market, which for ease of reference we shall call the middle-class mortgage market. Accordingly, table 3–2 also shows the growth in the GSEs' risk (mortgages and MBSs) as a proportion of that market.

Those data indicate that by 2003, Fannie is likely to hold in its portfolio 21 percent of all mortgages in that segment (line 10), and it will have assumed the risk (through holding mortgages in its portfolio or guaranteeing MBSs) of 37 percent of that market (line 13). In that same year, Fannie and Freddie together will hold in their portfolios about 36 percent of all middle-class

mortgages outstanding (line 22), and will bear the risk (through ownership of the underlying mortgages or guarantees of MBSs) of 63 percent of that entire market segment (line 25).

The numbers are even more dramatic if we consider only the conventional/conforming portion of the market. In that case, by the end of 1998, Fannie and Freddie had purchased and retained or guaranteed almost 74 percent of all the conventional/conforming mortgages outstanding (line 26). We project that by 2003 they will have assumed the risk of virtually all these mortgages—91.5 percent. It is no wonder, then, that Fannie and Freddie are advertising their efforts to acquire loans in the subprime categories. They are making a virtue of necessity, since their growth requirements leave them no choice.

Thus, if Fannie remains on the growth path forecast by Franklin Raines and if Freddie keeps pace, by the end of 2003 they will hold in their portfolios more than one-third of all middle-class residential mortgages in the United States (line 22), and more than a quarter (line 21) of all residential mortgages of any kind. Moreover, if we include their guarantees of MBSs, these two companies will be bearing the credit and other risk that is associated with almost half of all the mortgages outstanding (line 24), almost two-thirds of all middle-class mortgages (line 25), and more than 91 percent of all conventional/conforming mortgages (line 26).

In chapter 4 of this study, as those percentages suggest, we show that Fannie and Freddie can meet their growth objectives in the years ahead only by purchasing the riskier loans in the subprime, home equity, and multifamily categories. There will simply not be a sufficient amount of the higher quality, conventional/ conforming mortgages to meet their needs. So in addition to assuming a greater degree of risk simply through their growth over the next four years, the GSEs will also be increasing their overall risk by going

more deeply into the lower-quality sectors of the market that until now have been served satisfactorily by nonsubsidized lenders. We explore the nature and possible consequences of the GSEs' growing risk profiles in chapter 6 of this study.

Also, as the GSEs move into the lower-quality market sectors they have previously shunned, they will reduce the portfolio assets, revenues, and profits of thousands of mortgage lenders now active in that market. Although some might think that mortgage lenders will have a choice whether to sell the mortgages they originate to Fannie and Freddie, that is not really the case. Because the GSEs can offer lower government-supported rates for the mortgages they are willing to buy, no lender can offer a competitive rate against another lender who is willing to sell the resulting loan to Fannie or Freddie. Their lower rates also permit Fannie and Freddie to skim the cream from the mortgage markets, leaving other lenders with riskier loans to weaker borrowers. That problem will become more severe as Fannie and Freddie drive deeper into the subprime market.

In other words, if Fannie and Freddie are permitted to continue their growth, even if they don't move outside the secondary mortgage market itself, they will gradually strangle the other participants in the mortgage markets. Those markets will become more concentrated and less diverse than any other financial market in the United States and, increasingly, an obligation of the federal government rather than of the private sector. The impact on competition of Fannie and Freddie's growth is discussed in detail in chapter 5 of this study.

4
Growth

Table 4–1 presents data on the year-to-year growth in the mortgage assets of Fannie Mae and Freddie Mac since 1995. The information for the years 1995 through 1998 is taken from their financial statements; the projections for the years 1999 through 2003 are derived from the assumptions that were used in chapter 3 to project their asset totals for those years.

The data show Fannie and Freddie's growth as a percentage of the *growth* of: (1) the entire residential mortgage market (line 29); (2) the conventional/conforming portion of the market (line 32); and (3) the conventional/conforming plus "all other" portion of the market (line 35).

By presenting the information in that way, we are able to show that, as Fannie and Freddie grow in the year ahead, they will have to drive deeper and deeper into the subprime loan categories in order to find the assets their growth requires. Clearly, Fannie and Freddie cannot continue to grow indefinitely by purchasing and guaranteeing conventional/conforming mortgages. If the conventional/conforming loan market grows at the same rate as the market as a whole in each of the next four years, conventional/conforming mortgages outstanding will increase by $720 billion. But to maintain their projected growth rates, Fannie and Freddie will have to increase their mortgage investments and guarantees by $1 trillion. At the end of 1998, they had retained in their portfolios or guaranteed 74 percent of

those loans, and we project that by 2003 they will have retained or guaranteed almost 92 percent.

Thus, beginning in 1998, Fannie and Freddie together, to meet their combined growth goals, were required to add new assets at a rate that exceeded the growth in conventional/conforming mortgages that year. Line 30 of table 4–1 shows that in 1998, the total amount of conventional/conforming mortgage debt outstanding increased by $207 billion. But in that same year, Fannie and Freddie together added $250 billion in new mortgage assets and guarantees to their balance sheets, so that their increase in mortgage credit risk was 121 percent of the net increase in the conventional/conforming market (line 32). By 2003, Fannie and Freddie's need for new assets will equal 146 percent of all net new conventional/conforming loans.

Accordingly, unless they can break into the jumbo market through a change in law, or out-compete Ginnie Mae for a substantial share of the FHA-VA market, the only recourse for Fannie and Freddie is the subprime market.

However, the subprime market, as its name implies, involves considerably greater credit risk than does the conventional/conforming market. By entering that market, Fannie and Freddie will be taking on more risk than they have in the past—risk that may be only partially compensated by the higher interest rates and guarantee fees those mortgages generally yield. We cover that issue more fully in chapter 6.

TABLE 4–1

Growth in Residential Mortgages—Fannie Mae and Freddie Mac versus the Mortgage Totals, Past, Present, and Projected, 1995–2003
(dollars, in millions)

		History (Year-End)				Projection (Year-End)					Annual Growth Rate: 1995–1998 (%)	Annual Growth Rate: 1998–2003 (%)	Growth Rate Difference
		1995	1996	1997	1998	1999	2000	2001	2002	2003			
27	Annual growth in residential mortgage market—total		227,070	251,517	397,925	373,059	352,541	323,330	342,730	363,294	32.4	-1.8	-34.2
28	Growth in GSE portion		112,742	90,667	250,340	268,210	235,447	234,522	254,420	275,861	49.0	2.0	-47.1
29	GSE portion of total(%)		49.7	36.0	62.9	71.9	66.8	72.5	74.2	75.9			
30	Growth in conventional/ conforming—total		118,076	130,789	206,921	193,991	183,321	168,132	178,220	188,913	32.4	-1.8	-34.2
31	Growth in GSE portion		112,742	90,667	250,340	268,210	235,447	234,522	254,420	275,861	49.0	2.0	-47.1
32	GSE portion of total (%)		95.5	69.3	121.0	138.3	128.4	139.5	142.8	146.0			

33	Growth in conventional/ conforming & all other mortgages—total		161,945	186,473	338,882	295,077	279,580	256,987	272,915	289,814	44.7	−3.1	−47.7
34	Growth in GSE portion		112,742	90,667	250,340	276,079	236,348	235,420	255,394	276,917	49.0	2.0	−47.0
35	GSE portion of total (%)		69.6	48.6	73.9	93.6	84.5	91.6	93.6	95.5			
36	Nominal GDP—4th quarter	7,529,300	7,981,400	8,453,000	8,947,600	9,394,980	9,864,729	10,357,965	10,875,864	11,419,657	5.9	5.0	−0.9
37	GDP annual growth rate (%)		6.0	5.9	5.9	5.0	5.0	5.0	5.0	5.0			
38	Assumed growth rate after 1998 (%)	5.0											
39	Total mortgages outstanding/ GDP (%)	50.3	50.3	50.5	52.1	53.6	54.6	55.1	55.7	56.2			
40	Change in mortgage/GDP ratio (%)	0.6	0.0	0.2	1.7	1.5	1.0	0.5	0.5	0.5			

5
Threat to Private-Sector Competitors

Since Fannie and Freddie are growing faster than the mortgage market itself, their growth comes from taking market share, revenue, and profits from genuinely private-sector mortgage lenders. As shown earlier, to maintain the rate of profit growth on which their stock price depends, Fannie and Freddie must encroach further and further on the private sector. Although they had previously concentrated on the best and most creditworthy loans within the conventional/conforming sector—leaving to the banks, S&Ls, and other nonsubsidized lenders the subprime, home equity, and multifamily loans that represent greater default risks—they are now compelled to wade into that market and begin to take market share from the companies that are already there.

The figures in table 3–2 illustrate quite well the problem that confronts Fannie and Freddie's private-sector competitors. As shown by line 22, the GSEs' share of all residential mortgages (conventional/conforming and "all other") will grow from 19.5 percent at the end of 1998 to almost 36 percent at the end of 2003. That increase of 16.4 percentage points would equal approximately $800 billion, or 12.4 percent of the aggregate principal amount of all mortgages outstanding at the end of 2003. In other words, in four years, $800 billion in principal amount of mortgages—which would otherwise be in the portfolios of private-sector lenders now operating in those markets—will instead be in the

portfolios of Fannie and Freddie. That will substantially reduce the mortgage supply for the lenders now in the market, and will force many of them to leave the mortgage lending business entirely.

In effect, the growth of Fannie and Freddie is leading to a steady nationalization of the residential mortgage markets in the United States, without any debate—or even apparent awareness—by Congress.

As shown by lines 29, 32, and 35 of table 4–1, Fannie and Freddie must take most of the growth in mortgages outstanding if they are to meet their market share, revenue, and earnings growth objectives. Since they cannot meet their needs for product solely out of the conventional/conforming mortgages that will come to market between 1999 and 2003, they must look elsewhere for product.

One easy target would be the jumbo market, which will become available if Congress can be induced to eliminate the ceiling on conventional/conforming mortgages. Opening the door for Fannie and Freddie to enter the jumbo mortgage market would, by 2003, give them access to almost $1 trillion of mortgages that are now off-limits.

Other mortgage markets beckon to Fannie and Freddie, including those to be accessed by dipping deeper into the subprime loan pool and assuming the higher credit risks associated with those loans; by expanding more aggressively into the financing of multifamily housing designed for renters, not homeowners; and by acquiring home equity loans in addition to first mortgages. But those can be merely stopgaps. Our projections extend only through 2003; if the growth of Fannie and Freddie continues beyond that year at the rate Frank Raines has forecast, they will at some point acquire all the available residential mortgage product in the United States. As the practical limits of the residential mortgage market are reached, one can easily envision Fannie and Freddie arguing that they should extend their skills and cost advantages into the com-

mercial mortgage market. After all, many office building and shopping center owners would welcome the taxpayer subsidy Fannie and Freddie can deliver.

Fannie and Freddie's other opportunity for growth outside the residential mortgage market is to provide financial services generally, especially consumer credit services. Home equity loans, for example, provide a ready entry into consumer financial services. Once the GSEs hold a home equity loan, they have the opportunity to use it as a revolving loan fund with which Fannie and Freddie would be able to supply credit directly to the homeowner/borrower. Although in one sense that might be considered loan origination, such a determination would have to be made by the Department of Housing and Urban Development (HUD)—which in the past has shown little appetite for challenging Fannie and Freddie's expansion. If in fact that activity goes unchallenged by HUD, the GSEs could become very large sources of consumer credit, and through their implicit government subsidy they would be able to offer consumers better rates than banks and other consumer lenders.

Perhaps the greatest competitive threat, however, remains in the mortgage origination process. Although Fannie and Freddie vigorously deny that they have any intention to originate mortgages, pointing out that they lack the statutory authority to do so, what exactly constitutes origination of a mortgage is a matter of interpretation. If Fannie and Freddie were to open their automated underwriting facilities to direct borrower access over the Internet, it might be possible for them to provide the prospective homebuyer with a certification that his or her mortgage would qualify for purchase by Fannie or Freddie. At that point, the actual lender would have little to do except to perform the ministerial acts necessary to fund the loan and deliver it to one or another of the GSEs. The compensation for that role would, of course, be small.

In a November 1999 speech to securities analysts, Leland Brendsel, the chairman of Freddie Mac, referred in rather vague terms to major changes in the offing for the mortgage market:

> I can safely predict that within a few short years, the mortgage industry will change dramatically. When the dust settles in the mortgage market, we will be left with an industry structure where investor funds flow to consumers with little drag from antiquated, inefficient processes. Consumers will be able to tap global capital markets at even lower cost than they can today.

And later in the same statement he was even more explicit. Citing the potential of technology "to streamline the entire mortgage process and eliminate inefficiency in the housing finance system," he continued:

> Freddie Mac has brought tremendous efficiency to the mortgage market, but the industry still generates significant costs from redundant operations and expensive transfer of information through all the steps in the mortgage process. As technology wrings out remaining inefficiencies, Freddie Mac's role will be enhanced, as we deliver low-cost funds to consumers even faster and more effectively.

There can be little doubt that Mr. Brendsel was describing a mortgage industry in which, through technology, Freddie Mac would be dealing directly with borrowers and perhaps with consumers generally.

6
Risks

It is impossible to understand the risks that Fannie and Freddie create for the government and taxpayers without understanding their similarities to the S&Ls that collapsed at the end of the 1980s. Like the S&Ls,

- their principal investments are home mortgages, long-term assets that can abruptly become short-term assets when a home is sold or refinanced;
- they can borrow at government-assisted rates that do not substantially increase as they take on more risk;
- they are unable to manage risk through asset diversification because virtually all their assets are home mortgages.

But Fannie and Freddie are like 1980s S&Ls in another significant way. Scholars reviewing the S&L collapse have shown that it came about in substantial part because the industry was seeking high profits in order to recover the capital depleted by losses during the high-interest-rate period at the beginning of the 1980s. To achieve that profitability, through a process ultimately called "gambling for resurrection," the S&Ls reached for greater and greater risk. Although the debt market usually requires much higher interest rates from companies that are taking on increased risk—if those companies can access the debt market at all—that was not true for the S&Ls. Because their deposits were backed by the government, weak and failing S&Ls were

able to raise the necessary funds to keep on gambling—ultimately causing immense losses to the government and the taxpayers.

Of course, Fannie and Freddie are not weak companies, and they have no need to take risks to restore their capital. But they have strong—indeed, compelling—reasons to continue increasing their profitability. That circumstance creates the same incentives to take on risk that the managements of weak S&Ls confronted fifteen years ago.

The incentives are clear. Fannie and Freddie are public companies; their shares are listed on the New York Stock Exchange and are closely monitored by the investment community. The value that investors place on their stock at any given moment is not only a vote on their earnings growth prospects and the quality of their management, but also directly affects management's compensation. Like the managements of most large, publicly held companies, the managements of Fannie and Freddie are compensated in part through stock options, which in turn acquire increasing value only if the price of their stock increases.

That creates a strong incentive for the managements of the GSEs, like those of conventional private firms, to increase their profits and to impress investors with their potential for profit growth. For example, at the Merrill Lynch investor conference in September 1999, Fannie Mae chairman Franklin Raines projected that Fannie Mae would achieve annual earnings growth of 15 percent in 1999 and over the next four years. But profit growth at that rate is highly unusual. Fannie already boasts that it is one of only eight companies in the S&P 500 that can claim to have had a double-digit rate of earnings growth for twelve straight years. Continuing that growth in profitability—and indeed increasing it—would be extraordinary for any company in today's low-inflation environment.

We can only speculate why Mr. Raines would place

such a burden on himself and his management. Possibly it is because he wants to be seen as a highly capable manager, or he feels an obligation to match the success of his predecessors. However, the fact that his compensation and that of the top managers at Fannie Mae are tied to increases in Fannie's stock price also provides a substantial incentive to impress the financial markets.

Once we look at Fannie and Freddie as gigantic S&Ls that are seeking an almost unprecedented rate of profitability growth, we can begin to see why they create risks for the government and the taxpayers that parallel the risks created by the S&Ls in the 1980s. Because of their government backing, they are essentially exempt from debt market discipline—just like the insured S&Ls of the 1980s.

The incentives may be different, but the objectives are the same—to increase profitability by issuing debt at a government-backed rate, while achieving higher profitability through taking on greater risk. In the 1980s, S&Ls tried to do that to replenish their capital; Fannie and Freddie are doing it to maintain the profit growth that sustains a growing market valuation of their stock.

To be sure, Congress has attempted to address the question of GSE risk, using the familiar device of a regulatory agency. In 1991, Congress established the Office of Federal Housing Enterprise Oversight (OFHEO), a regulatory agency charged with supervising the GSEs the way banking regulators supervise banks and S&Ls. Given the experience of the 1980s—not only with the S&Ls but with banks themselves—we should be skeptical about the effectiveness of regulators in controlling the risks of the companies they regulate.

For one thing, there is always the question of asymmetric information—the regulated company knows more than its supervisor about the risks it is taking on. For another, as demonstrated in the case of the S&L industry, the regulated companies frequently have

more power to influence Congress than has the regulatory agency, and they are frequently successful in limiting the agency's resources. It is useful to recall that Congress repeatedly supported the S&L industry's efforts to avoid regulatory restriction on its activities. As it happens, in the case of OFHEO, that phenomenon was clearly demonstrated in 1999, when a Senate committee initially capped OFHEO's appropriation at the previous year's $16 million level—despite an administration request for a 20 percent increase. Although an increase to $19 million was ultimately voted, the special effort that was required sent a signal to OFHEO about how much congressional support it will receive if it seriously attempts to control Fannie and Freddie's behavior.

Even without those negative signals, there are good reasons to believe that OFHEO will not act to reduce the GSEs' risk-taking. For example, if Fannie or Freddie's capital ratios slipped too low, OFHEO could direct the troubled GSE to reduce its assets as part of a plan to strengthen its capital position. Shrinkage, however, implies that the GSE in question would sharply reduce its buying and guaranteeing of mortgages. It might even be required to sell assets. That would improve its capital ratios, but the cutback and asset sales could force an increase in mortgage interest rates and a sudden, sharp reduction in housing construction, with secondary effects throughout the economy.

The possibility that there might be severe macroeconomic consequences as a result of an OFHEO regulatory action should raise both systemic-risk concerns about OFHEO's new capital regulations and doubts about the likelihood that they will ever be effectively applied. If OFHEO's capital regulations are believed to threaten severe macroeconomic consequences—and certainly Fannie and Freddie will not be shy about pointing that out—it is easily foreseeable that Congress will act to prevent the enforcement of the regulations.

That example, not at all far-fetched, suggests how difficult it will be for OFHEO to be an effective source of discipline over Fannie and Freddie. And without OFHEO, there is effectively no means of controlling their risk-taking.

Nevertheless, OFHEO *has* proposed a regulation intended to control the riskiness of Fannie and Freddie—including a risk-based capital requirement that imposes capital penalties when risks are not adequately hedged. Undoubtedly, Fannie and Freddie will cite those regulations as a basis for quelling congressional concerns. The question, however, is whether it is reasonable to believe that Fannie and Freddie can achieve the extraordinary rates of growth they are projecting while keeping their risks within tolerable levels. If they do so, they will be unusual companies indeed.

The GSEs' sagging stock prices demonstrate that Wall Street is skeptical on that score. As shown on lines 52 and 55 of table 6–1, both GSEs have experienced a significant decline, per dollar of portfolio investment, since 1995. We project that that trend will continue through 2003. On January 12, 2000, Fannie's common stock closed 20 percent below its twelve-month high, while Freddie closed down a more troubling 28 percent for the same period. That development seems to be puzzling to Fannie Mae chairman Raines, who asked at the Merrill Lynch conference, "So why does the market trade Fannie Mae at a discount to the other companies with similar growth rates?"

There are two possible reasons.

First, some investors may have recognized that Fannie and Freddie are simply running out of room to grow by purchasing the high-quality conventional/conforming mortgages that have been their traditional assets, and that the cost of hedging the risks of lower-quality product may reduce their profitability.

Second, and more ominously, Fannie and Freddie's lagging stock prices may reflect a growing concern in

the equity markets that the GSEs are not adequately hedging their risks, so that their future earnings may be hit by losses on the riskier mortgages they are purchasing or guaranteeing today.

In addition to their inherent lack of diversification, Fannie and Freddie face a number of other risks as guarantors of MBSs and as holders of large portfolios of mortgages and MBSs. Those risks include credit risk, interest-rate risk, counterparty risk, and spread-compression risk, all of which are discussed more fully below. As we will show, each of those risks can be reduced or hedged, but doing so is costly and will inevitably reduce Fannie and Freddie's profitability. To compensate for those costs—while trying to maintain and surpass their past levels of profitability—they must take on still more risk, always keeping one step ahead of their regulator.

Credit Risk. In common with all housing lenders, the GSEs have enjoyed a substantial decline in their credit losses in recent years. Fannie's pre-tax losses, per mortgage dollar owned or guaranteed, dropped from 5.3 basis points in 1996 to 2.9 basis points in 1998 (table 6–2, line 59); Freddie's pre-tax credit losses dropped from 10.5 basis points in 1996 to 5.1 basis points in 1998 (line 65).

But the housing market is historically volatile, and it regularly passes through boom and bust periods related to national economic conditions, interest rates, and other factors. Completely exogenous factors—an example might be a change in the tax system that alters the deductibility of mortgage interest in a significant way—could have seriously adverse effects, for which the participants have no effective way to prepare. It is important to keep in mind that Fannie and Freddie will be more exposed to the risks of the housing market than any lenders in history, since their already unprece-

TABLE 6–1

FANNIE MAE AND FREDDIE MAC NET INCOME BY LINE OF BUSINESS, PAST, PRESENT, AND PROJECTED, 1995–2003
(dollars, in millions)

		History (Year-End)				*Projection (Year-End)*					*Annual Growth Rate: 1995–1998 (%)*	*Annual Growth Rate: 1998–2003 (%)*	*Growth Rate Difference*
		1995	1996	1997	1998	1999	2000	2001	2002	2003			
	Net income by line of business (basis points)												
	Fannie Mae:												
41	Portfolio investment	1,369	1,694	1,894	1,878	2,219	2,621	2,988	3,346	3,702	11.1	14.5	3.4
42	Credit guarantee	1,003	1,031	1,162	1,540	1,583	1,661	1,770	1,872	1,973	15.4	5.1	−10.3
43	Total	2,372	2,725	3,056	3,418	3,802	4,282	4,758	5,218	5,675	12.9	10.7	−2.3
44	Federal tax rate (%)	28.0	29.5	29.3	25.9								
	Freddie Mac:												
45	Portfolio investment	N.A.	785	892	1,021	1,305	1,591	1,857	2,116	2,372	14.0	18.4	4.3
46	Credit guarantee	N.A.	458	503	679	751	760	793	819	841	21.8	4.4	−17.4
47	Total	1,091	1,243	1,395	1,700	2,055	2,352	2,650	2,935	3,213	15.9	13.6	−2.4
48	Federal tax rate (%)	31.2	30.0	29.0	27.8								

	Fannie + Freddie:												
49	Portfolio investment	N.A.	2,479	2,786	2,899	3,524	4,212	4,846	5,462	6,074	8.1	15.9	7.8
50	Credit guarantee	N.A.	1,489	1,665	2,219	2,333	2,422	2,563	2,691	2,814	22.1	4.9	-17.2
51	Total	3,463	3,968	4,451	5,118	5,857	6,634	7,409	8,153	8,888	13.9	11.7	-2.2
	Net income per $ of business (basis points):												
	Fannie Mae:												
52	Portfolio investment		62.8	62.8	51.3	47.0	45.0	43.0	41.0	39.0			
53	Credit guarantee[a]		13.3	14.0	16.9	14.0	13.0	12.5	12.0	11.5			
54	Total		34.0	35.3	35.1	33.6	33.5	33.6	33.4	33.1			
	Freddie Mac:												
55	Portfolio investment		63.9	59.0	48.6	44.0	42.0	40.0	38.0	36.0			
56	Credit guarantee[a]		7.9	8.2	10.2	9.5	8.5	8.0	7.5	7.0			
57	Total		21.1	22.3	24.7	26.0	26.3	26.7	26.9	26.7			

a. Assumes no credit risk on GSE/government-guaranteed debt held in portfolio.
N.A. = not available

dented market shares will—as discussed earlier in this study—grow even larger in the future.

Obviously, credit risk is closely related to conditions in the general economy. In recent years, a sustained economic expansion, soon to be the longest in U.S. history, has brought unemployment to record lows while boosting incomes. Both of those factors have led to a steady rise in housing prices. Rising prices in turn have given homeowners more equity in their homes, which protects mortgage lenders and guarantors, notably Fannie and Freddie. However, an economic downturn could depress housing prices while causing a jump in mortgage delinquencies as the unemployment rate rises. Mortgage foreclosures would increase, substantially raising Fannie and Freddie's credit losses.

As Fannie and Freddie are also diving deeper into the pool of subprime mortgages, they will be in largely uncharted waters. Although Fannie and Freddie claim that technology has greatly increased their loan-underwriting capabilities, thereby lowering their risks in subprime lending, that assertion has not been tested by a recession. Further, because of lower down payments from more financially challenged borrowers on properties that may not hold their values well during an economic downturn, losses on subprime lending could be much higher than on higher-quality loans.

Unlike their deep knowledge of and databases on conventional/conforming loans, the GSEs' relative inexperience with the subprime market makes their judgments concerning the risks they are assuming much less sure. Thus, Fannie and Freddie face not only higher likely losses in subprime loans per dollar lent or guaranteed but also greater uncertainty as to how high those losses will be.

To cover their risks in those cases, Fannie and Freddie have in the past relied in part on private mortgage insurance, but recently they have been exploring various devices that would enable them to assume more

TABLE 6–2
CREDIT-RELATED EXPENSES FOR FANNIE MAE AND FREDDIE MAC, 1995–1998

		History (Year-End)			
		1995	1996	1997	1998
	Fannie Mae:				
58	Pre-tax credit-related expenses ($, in millions)		409	375	261
59	Pre-tax credit cost (B.P.)		5.3	4.5	2.9
60	Credit guaranty tax rate (%)		31.4	31.1	24.3
61	After-tax credit cost ($, in millions)		281	258	198
62	After-tax credit cost (B.P.)		3.6	3.1	2.2
63	Credit income before credit expense (B.P.)		16.9	17.1	19.1
	Freddie Mac:				
64	Pre-tax credit-related expenses ($, in millions)		608	529	342
65	Pre-tax credit cost (B.P.)		10.5	8.6	5.1
66	Credit guaranty tax rate (%)		28.2	28.4	28.2
67	After-tax credit cost ($, in millions)		437	379	246
68	After-tax credit cost (B.P.)		7.5	6.2	3.7
69	Credit income before credit expense (B.P.)		15.4	14.4	13.9
70	Difference: line 63 − line 69 (B.P.)		1.5	2.7	5.2
	Fannie Mae ($, in millions)	22,200	29,200	43,200	83,600
	% of total portfolio	8.8	10.2	13.6	20.1
	Freddie Mac ($, in millions)	7,665	10,056	12,567	29,817
	% of total portfolio	7.1	7.3	7.6	11.7

B.P. = basis points. 1 B.P. = .01%

Memoranda data—government/GSE securities in portfolio. They presumably have no credit risk.

of the mortgage insurer's risk and thus keep more of the profit for themselves. That is consistent with their desire to increase their profits, but obviously it will also increase their risks of loss in the event of a market turndown.

Finally, Fannie is seeking substantial loan growth in the multifamily housing market, specifically to meet affordable housing goals. Multifamily mortgages can be

much riskier than those for owner-occupied, single-family homes, as Freddie learned to its regret a few years ago, because tenant income is more vulnerable to economic downturns and rental property deterioration can be more severe than owner-occupied housing.

Credit-guarantee fees, per dollar of risk assumed, declined during 1999 for both Fannie and Freddie, reflecting lower credit costs as well as increased competition between them for the business of large mortgage originators. A decline in fees is probably only the visible portion of the competition between the GSEs for that business. It is likely that they are also placing their guarantees on MBSs that are backed by somewhat riskier pools of mortgages, for which they are also attempting to assume more of the risk previously taken by mortgage insurers. A sharp and largely unpredictable upswing in credit losses a few years hence could therefore result in substantial losses in their guarantee business.

Interest-Rate Risk. Fannie and Freddie's potential interest-rate risk is growing rapidly as they grow their mortgage portfolios. Those portfolios consist of both whole mortgages and MBSs. In just twenty-one months, from the end of 1997 to September 30, 1999, Fannie increased its mortgage investments by 59 percent, or $188 billion; Freddie's increase was 91 percent, or $150 billion.

Like the S&Ls before them, Fannie and Freddie are heavily dependent on short-term funding to finance the long-term, fixed-rate mortgages they own. That is the classic borrow-short-to-lend-long strategy that S&Ls pursued, with disastrous consequences, when interest rates skyrocketed in the early 1980s. On September 30, 1999, 41 percent of Fannie's debt matured within one year. Freddie was worse off on that date, with 51 percent of its debt due within one year. The two GSEs have tried to lessen their maturity mismatching

through various devices, such as callable debt and interest-rate hedging. But such devices are costly, as discussed below, and their extensive use will reduce the GSEs' profitability.

Theoretically, Fannie and Freddie can minimize their interest-rate risk in two ways. First, they can "match fund" their mortgage portfolios. That is, they can sell debt that matches the maturity of their mortgage investments. Maturity matching is complicated, though, by mortgage prepayments, which are not as predictable as risk managers would like. Because the ease and cost of mortgage refinancing have come down in recent years, mortgage prepayments accelerate dramatically whenever longer-term interest rates decline even moderately.

Prepayments create a maturity mismatch because longer-term funding now exceeds longer-term assets. To some extent, Fannie and Freddie can neutralize maturity mismatching by issuing debt that can be called, or repaid, before maturity. But callable debt carries a higher interest rate than noncallable debt, so Fannie and Freddie pay a price for that form of interest-rate risk protection.

The reverse form of interest-rate risk occurs when interest rates rise. In that case, there is likely to be a sharp slowdown in home sales and mortgage refinancing, so that low-rate mortgages remain on the GSEs' books longer than anticipated and have to be supported with higher-rate liabilities. That can result in substantial losses or profit reduction and is exactly what happened to the S&L industry when interest rates spiked in the late 1970s and early 1980s.

Second, Fannie and Freddie have reduced their exposure to higher rates through the use of various financial derivatives, largely interest-rate swaps. That is, for a fee, the two GSEs shift some of their interest-rate risk to third parties. That practice enables them to increase their reliance on cheaper short-term funding.

But derivatives can be costly, particularly when interest-rate volatility causes significant changes in the shape of the interest-rate yield curve.

Counterparty Risk. Hedging interest-rate risk through derivatives raises a separate risk—counterparty risk, which is essentially a form of credit risk. That is, will the counterparty be able to pay when called on to do so under a swap agreement or other form of derivative contract? Counterparty-risk assessment is not a simple process, though, particularly when the counterparty is another financial institution that has entered into many other financial contracts.

The increasing challenge Fannie and Freddie face as they grow larger is finding sufficient counterparty capacity among highly rated potential counterparties: that is, firms with AAA or AA credit ratings. At the end of 1998, 32 percent of Fannie's counterparty risk was with entities rated less than AA; 7 percent of its counterparty risk was with entities rated less than A. Freddie is less forthcoming about its counterparty risk, merely stating that at the end of 1998, its five largest counterparties, which accounted for 60 percent of its total counterparty exposure, were rated at least A+. Consequently, as Fannie and Freddie's risk-hedging needs grow, they may have to pay steadily higher fees for a given amount of protection while relying increasingly on less creditworthy counterparties.

Spread-Compression Risk. In terms of their desire to maintain their profitability, the most serious risk the two GSEs now confront is spread compression: that is, a narrowing of their interest margins. Spread compression has become quite evident at both companies, as reflected in the net income they earn on their portfolio investments per dollar of investment. In 1996, Fannie's net income (excluding the cost of credit risk) per dollar of portfolio investment was 62.8 basis points (table 6–1,

line 52); for the first half of 1999, that profit margin had declined to 49.3 basis points. Freddie has experienced a similar reduction—its net income, per dollar of portfolio investment, declined from 63.9 basis points in 1996 (table 6–1, line 55) to 46.6 basis points during the first half of 1999. During the third quarter of 1999, Freddie's interest margin declined seven points from the second quarter, which suggests that its net income per dollar of portfolio investment declined again.

Spread compression is occurring for two reasons. First, as Fannie and Freddie continue to grow, their sheer size and the demands they impose on the financial markets will force up their cost of obtaining credit and interest-rate protection, per dollar of protection obtained.

Second, Fannie and Freddie's purchases of mortgages and MBSs will drive up mortgage prices, thereby reducing mortgage yields, as their mortgage portfolio growth reaches and then exceeds the growth in those portions of the mortgage market where they can lawfully participate. That spread compression will negatively affect Fannie and Freddie's earnings growth and return on equity capital. For Fannie, those data will be found in table 6–1, line 43, and table 6–3, line 85; the comparable data for Freddie are in table 6–1, line 47, and table 6–3, line 100.

Lower mortgage and MBS yields in the face of rising risk-protection costs will squeeze Fannie and Freddie's net interest margins. Unless they can trim their operating costs to fully offset that squeeze, which is unlikely, they will experience even less net income per dollar of portfolio investment. That decline will lower their return on equity capital and slow their earnings growth.

In the face of that inevitable spread compression, Fannie and Freddie's managements will understandably be tempted to take greater risks—specifically, greater credit risk and increased interest-rate risk.

TABLE 6–3

Fannie Mae and Freddie Mac Capital Requirements, Past, Present, and Projected, 1995–2003
(dollars, in millions)

		History (Year-End)				Projection (Year-End)					Annual Growth Rate: 1995–1998 (%)	Annual Growth Rate: 1998–2003 (%)	Growth Rate Difference
		1995	1996	1997	1998	1999	2000	2001	2002	2003			
	Fannie Mae:												
71	Core capital (OFHEO-defined)	10,959	12,773	13,793	15,465	18,668	22,109	25,811	29,456	33,602	12.2	16.8	4.6
72	Required minimum capital	10,451	11,466	12,703	15,334	18,168	21,359	24,811	28,456	32,602	13.6	16.3	2.7
73	Core—required minimum	508	1,307	1,090	131	500	750	1,000	1,000	1,000			
74	Mortgage portfolio (net)	252,588	286,259	316,316	415,223	528,811	635,882	754,006	877,960	1,020,492	18.0	19.7	1.7
75	Other assets	63,962	64,782	75,357	69,791	61,007	73,360	86,987	101,287	117,730	2.9	11.0	8.1
76	Total assets on B/S	316,550	351,041	391,673	485,014	589,818	709,242	840,993	979,247	1,138,222	15.3	18.6	3.3
77	Other assets/total assets (%)	20.2	18.5	19.2	14.4	10.3	10.3	10.3	10.3	10.3			
78	Calculated minimum capital:												
	Assets on B/S (2.5%)	7,914	8,776	9,792	12,125	14,745	17,731	21,025	24,481	28,456	15.3	18.6	3.3
79	MBS, other off-B/S (.45%)	2,310	2,467	2,606	2,867	3,060	3,201	3,290	3,406	3,495	7.5	4.0	-3.4
80	Other capital requirement	228	223	305	342	363	427	496	569	652	14.5	13.8	-0.7
81	Other/total capital required (%)	2.2	1.9	2.4	2.2	2.0	2.0	2.0	2.0	2.0			
82	After-tax income for dividends, stock buy-backs, other		911	2,036	1,746	599	841	1,056	1,573	1,529			
83	Net income (%)		33.4	66.6	51.1	15.7	19.6	22.2	30.1	26.9			
84	Dividend payout rate (%)[a]		31.5	30.9	30.9								

85	After-tax return on core capital, before preferred dividends (%)		23.0	23.0	23.4	22.3	21.0	19.9	18.9	18.0			
	Freddie Mac:												
86	Core capital (OFHEO-defined)	5,829	6,743	7,376	10,715	12,229	14,728	17,248	20,019	23,062	22.5	16.6	-5.9
87	Required minimum capital	5,584	6,517	7,082	10,333	11,829	14,228	16,748	19,519	22,562	22.8	16.9	-5.9
88	Core—required minimum	245	226	294	382	400	500	500	500	500			
89	Mortgage portfolio (net)	107,424	137,520	164,250	255,348	337,432	420,329	508,383	605,489	712,419	33.5	22.8	-10.7
90	Other assets	29,757	36,346	30,347	66,073	37,492	46,703	56,487	67,277	79,158	30.5	3.7	-26.8
91	Total assets on B/S	137,181	173,866	194,597	321,421	374,924	467,632	564,870	672,766	791,577	32.8	19.8	-13.1
92	Other assets/total assets (%)	21.7	20.9	15.6	20.6	10.0	10.0	10.0	10.0	10.0			
93	Calculated minimum capital:												
	Assets on B/S (2.5%)	3,430	4,347	4,865	8,036	9,373	11,676	14,122	16,819	19,789	32.8	19.8	-13.1
94	MBS, other off-B/S (.45%)	2,066	2,129	2,142	2,153	2,289	2,352	2,391	2,425	2,455	1.4	2.7	1.3
95	Other capital requirement	89	42	75	145	167	200	236	275	318	17.7	17.0	-0.7
96	Other/total capital required (%)	1.6	0.6	1.1	1.4	2.0	2.0	2.0	2.0	2.0			
97	A-T income for dividends, stock buy-backs, other		329	762	(1,639)	542	(148)	131	164	170			
98	Net income (%)		26.5	54.6	96.4	26.4	6.3	4.9	5.6	5.3			
99	Dividend payout rate (%)[a]		26.0	26.5	26.3								
100	After-tax return on core capital, before preferred dividends (%)		19.8	19.8	18.8	17.9	17.4	16.6	15.8	14.9			

a. Common + preferred dividends as a percentage of net income.
B/S = balance sheet.

That temptation is troubling, given their extremely thin capital cushions. Under existing regulations, Fannie and Freddie must have, at a minimum, equity capital (common stock, permanent preferred stock, paid-in capital, and retained earnings) equal to 2.5 percent of on-balance-sheet assets plus .45 percent of outstanding MBS and other off-balance-sheet obligations. The on-balance-sheet capital ratio is one-half the leverage capital ratio required for commercial banks considered to be well capitalized for regulatory purposes. Worse, as is clear from table 6-3, lines 73 and 88, Fannie and Freddie operate much closer to their minimum capital ratio requirement than is generally true for well-capitalized banks, which generally have risk-based capital of 10 percent. Therefore, increased risk-taking, which might not be immediately evident to regulators and stock market analysts, could set up either company—or both—for serious financial difficulties.

Systemic Risk. As Fannie and Freddie continue to grow, they will pose increased systemic risk to the U.S. financial markets. They had $866 billion of debt outstanding as of September 30, 1999. By the end of 2003, that amount will increase by almost $1 trillion, rising to $1.8 trillion (table 6–4, line 105). At that point, or shortly thereafter, the combined debt of the two GSEs may exceed the Treasury debt held by the general public—if budget surpluses continue to shrink the amount of Treasury debt outstanding.

Recently, Fannie and Freddie have been attempting to emphasize the similarity of their debt to Treasury securities, by mimicking Treasury's frequent, regular issuances of new debt. Indeed, at one point Fannie Mae's website contained the statement that its debt securities "will often provide investors with a spread pickup to the Treasury structure." In other words, investors can receive substantially the same security as Treasury debt with an interest-rate premium. If those

TABLE 6–4

FANNIE MAE AND FREDDIE MAC INTEREST-BEARING DEBT OUTSTANDING, PAST, PRESENT, AND PROJECTED, 1995–2003 (dollars, in millions)

		History (Year-End)				Projection (Year-End)					Annual Growth Rate: 1995–1998 (%)	Annual Growth Rate: 1998–2003 (%)	Growth Rate Difference
		1995	1996	1997	1998	1999	2000	2001	2002	2003			
	Fannie Mae:												
101	Interest-bearing debt O/S	299,174	331,270	369,774	460,291	560,327	673,780	798,943	930,285	1,081,311	15.4	18.6	3.2
102	O/S debt as percentage of total assets	94.5	94.4	94.4	94.9	95.0	95.0	95.0	95.0	95.0			
	Freddie Mac:												
103	Interest-bearing debt O/S	119,328	156,491	172,321	287,234	337,432	420,329	508,383	605,489	712,419	34.0	19.9	−14.1
104	O/S debt as percentage of total assets	87.0	90.0	88.6	89.4	90.0	90.0	90.0	90.0	90.0			
105	Total O/S interest-bearing Fannie and Freddie debt	418,502	487,761	542,095	747,525	897,759	1,094,109	1,307,326	1,535,774	1,793,730	21.3	19.1	−2.2

O/S = outstanding

marketing efforts are successful, actual losses at either of the GSEs—or a perception in the markets of a sudden increase in their riskiness—could result in a serious systemic problem for the economy as a whole.

Despite their efforts to present their securities as substitutes for Treasury securities, Fannie and Freddie are not the Treasury. Their securities are only implicitly backed by the U.S. government; they do not carry the full-faith-and-credit promise of the United States. Indeed, the GSEs' securities are by statute required to state that they are *not* obligations of the United States. They are able to obtain favorable financing because the markets do not believe—given the GSEs' many connections with the U.S. government—that they will be allowed to fail.

But it is important to understand that that condition still leaves some room for doubt. Ultimately the GSEs' ability to fund themselves in the financial markets depends on their ability to manage their risks as well as on conditions in the U.S. housing markets. The housing markets, in turn, are subject to risks—such as changes in the tax code—that cannot be anticipated. An adverse change in the GSEs' financial condition could lead to an increase in the yield spread of the GSEs' debt over Treasury debt. That could be a gradual rise, as the market worries about whether their implicit backing will turn into a bailout, or it could reflect a sudden shift in market perceptions. In the case of Farm Credit System (FCS) debt in 1987, a gradual rise was followed by a sudden tipping point, when the market fled to quality. In the case of the Farm Credit System, the yield spread over longer-term Treasuries went above 100 basis points, signaling that new FCS debt might become unmarketable.[8]

If a similar phenomenon should affect Fannie or Freddie's securities, the financial intermediaries that are currently holding that debt instead of Treasuries may find that they can sell only at substantial losses;

the losses would then raise questions about their own financial stability, and a systemic crisis would arise. To be sure, Congress could resolve the crisis, but a great deal of damage would then have been done to the economy as the market fled to quality and credit sources dried up. The U.S. financial markets experienced that phenomenon during the fall of 1998, in the aftermath of the Russian debt crisis and the Long-Term Capital Management debacle.

Of course, the effect of a Fannie and Freddie crisis would be even more calamitous for the housing markets. If those GSEs were to face substantially higher interest costs in marketing their debt, the costs would be transmitted immediately to the housing market—slowing home purchases and new home construction dramatically. That in itself would have a severely adverse effect on the general health of the U.S. economy.

Fannie and Freddie can contain their risks, but at the cost of reduced profitability. There is no indication in their behavior thus far that they are willing to accept that result.

7
Conclusion

Fannie Mae and Freddie Mac are fast becoming a problem that can no longer be ignored. By 2003, they will have assumed the risk—either through ownership or guarantees—of almost one-half of all residential housing mortgages in the United States. In effect, the residential mortgage market will have been partially nationalized, with the taxpayers bearing a risk that should be borne by private stockholders and creditors.

Moreover, we project that in 2003, Fannie and Freddie will own or have guaranteed 91.5 percent of all conventional/conforming mortgages, justifying the concern of private mortgage lenders throughout the United States that they will gradually be squeezed out of their traditional markets, and that Fannie and Freddie are planning to extend their activities to some form of direct relationship with the public.

It seems clear that the problem here is the peculiar structure of Fannie and Freddie—profit-seeking companies that have been granted special status to pursue a public mission. Those objectives are contradictory. Whatever balance Congress initially thought could be achieved between them has been lost.

What are the benefits that Fannie Mae and Freddie Mac claim to provide, and are those benefits worth the cost in taxpayer risk and competition for nonsubsidized mortgage lenders?

Although the GSEs do contribute to liquidity in the mortgage markets, they are no longer necessary for that purpose; private firms now routinely acquire and

securitize portfolios of jumbo mortgages—which exceed the size that Fannie and Freddie may purchase—and those private firms could certainly do the same for conventional/conforming loans.

Recognizing the validity of that argument, Fannie and Freddie now claim that their purpose is to reduce middle-class mortgage rates, and point to the fact that those rates are about 30 basis points lower than rates in the jumbo market. However, many economists have noted that that saving for homebuyers is an illusion: the lower interest rate is immediately capitalized into the cost of the home, so that the real benefit of the implicit subsidy goes to developers and homesellers rather than to the homebuyers whom Congress presumably intended to assist.

Weighed against those highly conjectural benefits are the real taxpayer risks that Fannie and Freddie create, and the real danger that they will eventually evict private nonsubsidized lenders from the residential mortgage market.

Policymakers have a number of appropriate potential responses: true privatization of Fannie and Freddie through cutting their links to the federal government; tighter statutory and regulatory restrictions on their efforts to expand their activities; limitations on their use of lobbyists, their political contributions, and their other efforts to manipulate the legislative process; free sale of identical GSE franchises, or the imposition of special taxes, affordable housing burdens, or other costs that would enable the government to recapture their implicit subsidy; forbidding the tying of management compensation to their stock price; and even returning them to their former status as on-budget federal agencies.

Whatever the course ultimately adopted, it is important to recognize that options are foreclosed and solutions become more difficult as Fannie Mae and Freddie Mac continue their de facto nationalization of the residential mortgage market.

BANKING AND CREDIT

Do the benefits exceed the costs? Are there viable alternatives?

A Microeconomic Analysis of Fannie Mae and Freddie Mac

By Robert Van Order

The most important public policy issues raised by government-sponsored enterprises (GSEs) like Fannie Mae and Freddie Mac (F and F) revolve around their charters and the perception of government support that goes with the charters, giving them "embedded options" not available to most other businesses. These options mostly take the form of conjectured guarantees and conjectures about conjectured guarantees. The options affect prices and provide incentives. They can be viewed as either subsidies or tools. Of course they are both. Public policy should be about making sure that the options are structured and regulated so that the benefits of GSEs exceed their costs.

My focus is on methodology and research questions rather than specific answers. I shall propose some simple models that are consistent with history but are mainly meant to be illuminating counterexamples rather than well-developed theories. I want to do two things: first, analyze what standard welfare economics has to say about policy and GSEs, and, second, analyze what existing data can and cannot support about the effects of GSEs. My conclusions are that welfare economics is ambiguous and that data are too shaky and empirical work is too sparse to support much of anything about the effects of F and F.

Robert Van Order is chief economist for Freddie Mac. This article represents the views of the author and not necessarily those of Freddie Mac. A preliminary version of this article was presented at an American Enterprise Institute conference in 1999. (See Robert Van Order, "Notes on the Economics of Fannie Mae and Freddie Mac," in *Fannie Mae and Freddie Mac: Public Purposes and Private Interests*, vol. 1, edited by Peter J. Wallison, American Enterprise Institute, 1999.) Future issues of *Regulation* will carry alternative views about Fannie Mae and Freddie Mac.

There is little hard evidence on the magnitude of either costs or benefits.

Taking the economics of the question seriously limits the things that can be believed simultaneously. For instance, it is difficult to believe both that F and F convey distortionary subsidies to the mortgage markets, which makes mortgage rates too low, and that they stifle competition, which makes rates too high.

SOME HISTORY

The structure of the mortgage market has changed dramatically in the last quarter century, primarily because of the rise of the secondary markets. This rise has come about largely because of standardization of pools of mortgages brought on by three secondary market agencies: the Federal National Mortgage Association (Fannie Mae), the Government National Mortgage Association (Ginnie Mae), and the Federal Home Loan Mortgage Corporation (Freddie Mac). Annual sales of mortgages to these three institutions have risen from $69 billion in 1980 to about $700 billion in 1999; they now own or are responsible for about

half of the outstanding stock of single-family mortgages. This growth has been accompanied by a decline in the market share of the traditional lenders, thrift institutions (e.g., savings and loans).

Fannie Mae, the oldest of the agencies, was established in the 1930s as a government-owned secondary market for newly created Federal Housing Administration (FHA) loans. For much of its history it operated like a national savings and loan, gathering funds by issuing its own debt and buying mortgages that were held in portfolio. This was a particularly useful function during credit crunches when deposit rate ceilings limited the ability of savings and loans to raise money. Fannie Mae was, in effect, the only deregulated and nationwide savings and loan.

The market share of depositories has risen in the 1990s. Currently about 60 percent of conventional loan originations do not go to Fannie Mae and Freddie Mac.

In 1968 Fannie Mae was moved off budget and set up as a shareholder-owned GSE, which in the 1970s switched its focus toward conventional (non-government-insured) loans. Ginnie Mae was created in 1968 to handle Fannie Mae's policy-related tasks and to provide a secondary market for government-insured loans. It developed the first mortgage-backed security in 1970. It is on the federal budget as a part of the U.S. Department of Housing and Urban Development (HUD). Freddie Mac was created in 1970 to be a secondary market for the savings and loans. Like Fannie Mae it is a GSE. It initiated the first MBS program for conventional loans in 1971.

Because Ginnie Mae is on budget its securities have a full faith and credit federal guarantee. Because Freddie Mac and Fannie Mae are private corporations neither has an explicit guarantee, but both have a nebulous, "conjectured" guarantee, a perception by the financial markets that the government stands behind their debt, which allows them to borrow (or sell mortgage-backed securities) at interest rates lower than they would otherwise. Both are regulated by HUD for their public-purpose missions and by the Office of Federal Housing Enterprise Oversight (OFHEO) for safety and soundness. F and F are now quite similar and compete in the conventional mortgage market as buyers of mortgages and in the securities markets as sellers of mortgage-backed securities and issuers of debt. Their main constraint in the conventional market is that they cannot buy loans above the "conforming loan limit," which is $252,700 for a single-family mortgage in 2000 and which is adjusted each year by an index of house prices. About 20 percent of the conventional market (in dollars) is above the conforming loan limit.

The reasons for starting up the secondary market in the United States are not the same as the reasons for its continuation. For instance, Fannie Mae was created because of the Great Depression, the collapse of housing markets, and the reluctance of lenders to invest in the new FHA loans; it was privatized in 1968 to get it off budget because of budget pressures from the Vietnam War. Deposit rate ceilings, which limited the ability of thrifts to raise money for mortgage loans, were a major factor in the rising importance of Fannie Mae in the 1960s and 1970s and in the creation of Freddie Mac in 1970, but deposit rate ceilings no longer exist. Similarly, the inability of thrifts to operate nationally was also important in the rise of the secondary markets, but national deposit markets and liberalized branching rules have limited the importance of this factor. None of these are important issues any more.

The main reason now for the important role of F and F is that they have been a low-cost way of raising money. That is primarily because of economies of raising money wholesale in the capital markets, economies in purchasing and servicing of large numbers of mortgages, and because their charter gives them benefits that are comparable to those received by thrifts (more broadly depository institutions)—for example, from deposit insurance. However, depositories remain a major source of funds. The markets in which they raise money have become more efficient, they have increased access to fee rather than interest income from loans, they have information advantages because they originate loans and can select better loan customers than F and F, and they have a genuine full faith and credit guarantee from the government. Their market share has risen in the 1990s. Currently about 60 percent of conventional loan originations (half of conventional conforming) do not go to Fannie Mae and Freddie Mac.

MICROFOUNDATIONS

THE ANALYSIS OF GSES NEEDS A MICROECONOMIC FOUNDATION. My analysis is as follows.

The Industry The relevant industry for F and F is not the secondary market but the mortgage market as a whole. The distinction between the primary and secondary markets is largely irrelevant, economically. What matters is that there are different ways of getting money from capital markets as a whole to the mortgage market. There are two major routes for conventional mortgages: via depositories and via F and F. Both take advantage of some sort of federal backing. The fully "private" market is small and has been small for at least the past 60 years. The development of the mortgage market over the past 25 years has largely been characterized by one type of federally sponsored institution (GSEs) taking some of the market share of another (the depositories).

The competitive structure might best be characterized as "dueling charters" (a variant of a description used by

Michael Lea (see "Dueling Guarantees" in *Secondary Mortgage Markets*). That is, there are two major charters in the industry: one for depositories and one for GSEs. Both involve embedded options, and both have offsetting restrictions on lines of business, capital regulation, and mission regulation. Both types of charter promote different ways of connecting mortgage markets with the financial markets. Historically the competitive balance between the charters has been determined primarily by cyclical movements in thrift capital levels and by the balance between the economies F and F have in raising money (and their lower other costs) with the advantages local depositories have in selecting the best loans. Banks are no more "private" than GSEs.

There is competition. The F and F share of originations in the conventional market was high in the early 1990s when the savings and loans were in trouble, but it has fallen since. It was more than 60 percent in 1993, but it fell to less than 30 percent for a while in 1994 and has fluctuated since, mostly around 40 percent (about half of conventional conforming). I do not claim that price equals marginal cost; rather I do not believe that the difference between price and marginal cost in the mortgage market is different from that in most other industries. Economic theory says little more than that in an industry like the mortgage industry price will be somewhere between the monopoly price and marginal cost, and there has not been empirical work that can tell us much about which end of the spectrum is closer to the truth.

High returns over the past decade do not suggest a lot of risk taking, but Fannie Mae's experience in the early 1980's suggests that large bets are possible.

Benefits of the GSE Charter Whether (and the extent to which) F and F get a subsidy has been a source of controversy. It is clear that they borrow at lower rates than they would if they had the same portfolio but a different (and nondepository) charter. Recent "stand alone" ratings by Standard and Poor's put both companies in the (low) double A (AA) range on their own, but they borrow at less than triple A (AAA) rates. This difference looks like a subsidy. It is off budget, not all of it can be considered a net benefit, and it is not just a guarantee fee in the sense of measuring the expected costs to taxpayers of a bailout (e.g., it includes other charter benefits, like scale economies, and scarcity of the charter, which are benefits but do not increase probability of bankruptcy and may decrease it). Nonetheless, in terms of economics it acts like a subsidy, and it affects resource allocation like a subsidy. But words can be confusing; so I choose to call it a "benefit" and distinguish between the gross benefit, which equals the spread just discussed, and the net benefit, which is what actually affects resource allocation. This distinction is discussed below.

The size of the gross benefit should be straightforward to measure; it is relatively easy to look up interest rate spreads for comparable debt. Use of Bloomberg data like those used in a 1996 U.S. Department of the Treasury study (*Government Sponsorship of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation*) results in a spread between GSE and AA interest rates for comparable debt that ranges from about 15 to 36 basis points (bp) since 1992. (A basis point is equal to a hundredth of a percentage point.) For A the range has been 20 to 75 bp. A reasonable range, then, is something like 20 to 40 or 50 bp, currently on the low side of the range, rather than the higher levels quoted in the Treasury study and a study by the Congressional Budget Office (CBO) (*Assessing the Public Costs and Benefits of Fannie Mae and Freddie Mac*). The reason Treasury's study had higher spreads is primarily that it looked at single A rate spreads (rather than AA minus) and spreads have fallen since then.

Offsetting some of the benefits of the GSE charter are costs of constraints from the charter, which should be netted out. On the other hand there are other advantages such as exemptions from state and local (but not federal or property) income taxes and Securities and Exchange Commission registration. These are probably worth on the order of a few basis points but are dominated by variations in borrowing spreads.

Similar calculations can, in principle, be made for depositories by comparing the cost of their (uninsured) debt with the cost of deposits. The calculations are difficult because the debt of most depositories is unrated, but it is doubtful that much of the industry is close to A or AA. Few banks have ratings of AA or better (none are AAA now); most are in the A to BBB range. Most thrift institutions that are rated are BBB or worse, and the unrated part of the industry is probably worse than these ratings. Deposit insurance premiums should be netted out, when they are paid (most depositories currently do not pay premiums). For instance, if the deposit insurance premium is 20 bp and the GSE benefit is 30 bp, then the benefit to depositories is greater than the benefit to GSEs if depositories would have to pay 50 bp or more than current deposit rates absent deposit insurance. Bloomberg data suggest that, as a crude benchmark, spreads between GSE debt and BBB tend to be between 40 and 100 bp (from 1992 through 1998). At the end of 1998 it was high at a bit over 100. Spreads from Treasuries have run between 50 and 160.

These calculations, like those in the CBO, Treasury, and other studies, focus on debt costs. Equity does not receive many direct benefits from either charter (e.g., GSEs do not pay state income taxes). The main benefit is that

equity investors benefit indirectly from lower debt costs. Both depositories and GSEs are mainly debt financed, so equity costs are a small part of the overall costs of funds. Nonetheless, debt-to-equity ratios for the two charters are not the same, and the interactions of different ratios with the tax treatment of equity and debt (debt is tax-favored relative to equity) may also have implications for cost differences across charters.

Incentives GSEs and depositories can be expected to take account of their charter benefits when they make decisions. A value-maximizing firm with a completely unconstrained guarantee will tend to take on as much risk as it can in order to exploit the guarantee. But guarantees are never unconstrained. If it is possible for the institution to be shut down or for management and shareholders to lose control of the company, it will have incentives to control risk so as to maintain access to future benefits. Thus, although a guarantee might produce incentives to take excessive risk, GSEs also have a franchise that induces them to be conservative.

Of course both F and F take on some risk. Their franchise is worthless if all they do is hold the equivalent of match-funded Treasuries. The major risk of risk-taking comes from the extent to which GSEs have the option to take on more risk (gamble for resurrection) if they do get into trouble, the franchise depreciates in value, and the regulators do not catch on fast enough. Theory suggests that F and F will balance franchise and guarantee considerations, but it provides little insight into how much risk they will take. The consistently high returns for both institutions over the past decade do not suggest a lot of risk-taking, but Fannie Mae's experience with losses from interest rate risk in the early 1980s suggests that large bets are possible.

Why Have GSEs? GSEs are a compromise between government agencies, like Ginnie Mae, and fully private businesses. The justification for such hybrids must be that there is some policy goal that can be accomplished better with private sector incentives (e.g., profit maximization and cost minimization). The main policy problem is balancing these efficiencies with incentives to exploit embedded options. The major rationales for GSEs are as follows:

Demonstration Effects Information has a public good component. Investors in projects that provide information will bear the burden of failure but will be imitated by competitors if successful. Because of their size, F and F can capture much of the benefit of their investments in a way that smaller depositories cannot, and there is an external benefit to other firms from finding out what works—for example, the structure of mortgage-backed securities, mortgage derivatives, and new (e.g., low income) markets. It might be argued that this effect will fade over time; although recent developments in automated underwriting by F and F, which are being imitated in the rest of the industry, suggest this is not entirely true.

Homeownership Externalities It has been argued that homeownership provides external benefits in the form of better citizens. There are other tools (like the tax code) that promote homeownership. Nonetheless, F and F could be beneficial, particularly if benefits are targeted to particular, underserved, groups for whom the homeownership externality is greatest and who might be hard to target with other (e. g., tax benefits) policies.

Keeping Markets Open Financial markets sometimes collapse—sometimes in big ways, as in the 1930s in the United States and in 1998 in Asia, and sometimes in smaller ways, as in 1998 in the United States. These collapses provide false price signals by changing spreads among various borrowing rates and allocating capital less efficiently. GSEs have a stake in market stability and can improve markets by being a lender of last resort. The ability to borrow large amounts quickly makes this easier, and the information that comes from being an important actor in the market can make stabilization profitable even in the short run.

A More Efficient Way of Supporting Mortgage Markets than Depositories. If subsidies conveyed by deposit insurance are expensive, F and F may be a cheaper alternative, or easier to regulate, or both (as opposed to more than 10,000 depositories).

All of these rationales are controversial, and all are quite difficult to quantify. Although there are numerous anecdotes, there has been no hard empirical evidence that sheds much light, for better or worse, on the magnitude of these effects.

MODELING FANNIE AND FREDDIE AND THEIR MARKET

GSES CAN BE THOUGHT OF AS HAVING EXTENDED BALANCE sheets with two implicit assets: G, the conjectured guarantee, which gives them lower borrowing rates; and F, the franchise. Otherwise they have a collection of assets, liabilities, and shareholder equity that is constrained by their charter. In the simplest case G is the present value of lower borrowing costs for the current book of business, and F is the present value of lower borrowing costs for future books of business. But more broadly, F is the ability to get all future benefits of the charter as well as the usual franchise elements accruing to all firms that act as ongoing businesses.

Modeling F and F's decisionmaking comes from modeling their optimization subject to regulatory structure and closure rules. This will give implications for their risk exposure (from the trade-off between G and F) and their supply of funds. The value of G + F will show up in the stock price and contribute to market value exceeding book. However, it is difficult to go backward to infer the value of G + F from the excess of market over book and even more difficult to separate G from F. One can derive a supply curve for depositories in a similar way.

Welfare Effects Welfare effects of GSEs inevitably involve second-best considerations because the rationale for GSEs requires market imperfections in the first place. The criticism by economists of guarantees has generally been that they distort prices and resource allocation by diverting funds toward resources affected by the holder of the guarantee (in this case housing) and away from other types of uses (in this case other investment). Proponents argue, however, that GSEs produce external benefits, such as stabilizing the market and promoting homeownership.

Dueling Charter Models of Mortgage Markets I shall begin with a specific second-best model that trades on the relative charter benefits for F and F versus depositories (taken from the fourth rationale above). I shall then discuss a model in which there are externalities.

Model I The first model focuses on comparison with depositories. There are no externalities, the private demand for mortgage funds fully reflects social benefits of mortgages and the housing they finance, and general equilibrium effects are ignored. It is assumed that supply curves are flat and reflect normal profits. I begin with a fully private supply curve, which in this case I assume reflects marginal social as well as private costs. Total social benefits and costs are given by the areas under the demand and supply curves, respectively. Equilibrium is at point B in Model 1. It is a social optimum because marginal social costs equal marginal social benefits.

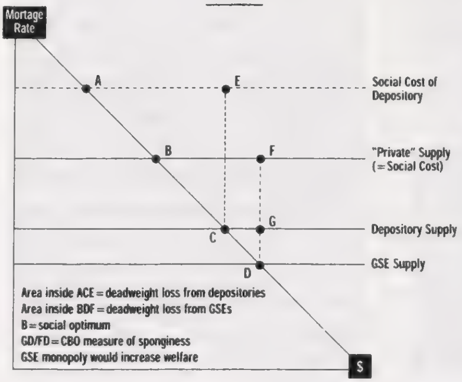
Now introduce depositories, which are assumed (e.g., because of regulatory costs) to have social costs greater than those of the fully private market, but they are assumed to have a borrowing cost advantage from their charter equal to EC, so that the actual supply curve in the market is one with the points C and G on it, whereas the unsubsidized supply curve, which depicts social costs of depositories, has the points A and E on it. In this model the depositories dominate the fully private market because of their lower costs. The excess of total social costs above total social benefits, or deadweight loss, from the depositories is the area inside the triangle AEC.

Now introduce GSEs with the same social costs as the private, nondepository, suppliers but with a charter benefit such that they have lower private costs than either depositories or the private suppliers. Assume that they are competitive, so that they have a supply curve like depositories (including normal profits), but it is the lowest of the curves, with the point D on it. In this model the market is segmented. There is no "private" market, and the conventional market is divided between the conforming market (mortgages of less than $252,700 in 2000), which goes to GSEs, and the nonconforming market (mortgages of more than $252,700 in 2000), which goes to the depositories.

The deadweight loss in the conforming market is now the area inside the triangle BFD. This can be either bigger or smaller than the deadweight loss from the entirely depository based system, depending on the size of the gross benefit (the Treasury-CBO type of estimate) to GSEs relative to the gross benefit (net of deposit insurance premiums) to depositories (in the example above, whether or not depositories could attract deposits at 50 bp or less absent insurance). Intuitively, in this model GSEs have lower production costs than depositories, which tends to be welfare increasing, but they lower already distorted mortgage rates, which is welfare reducing.

The gross benefit to GSEs can be broken up into two parts: FG, which is what is necessary to get them into the industry, by being competitive with depositories; and GD, which is the net benefit and equals the extent to which they lower mortgage rates, and in this model that equals the difference between the conforming and nonconforming rates.

Model 1



Model 2 Model 1 is very much a second-best model, with no particular reason for intervening in mortgage markets in the first place. Suppose that at least one of the first three rationales above is valid for GSEs, and it (or they) can be represented by GSEs having a lower social cost than their private cost (similar social benefits could hold for depositories, but I assume GSEs still have lower costs). This is depicted in Model 2, which is the same as Model 1, but with the lower social costs of GSEs given by the line with KHI and J on it. In this model the GSE market supply curve is given by the same one as before (with D on it). The social optimum, where marginal social benefits equal marginal social costs, is at H.

As the curves are drawn in the figure, neither the fully private market solution (which pro-

duces too small a market), the depository-based market solution (which has too big a market), nor the GSE-based market (which also produces too big a market) is first best. The deadweight loss from the purely private market is the area inside the triangle KBH, and the deadweight loss from GSEs is HJD, which is less than the deadweight loss was in Model 1. Getting to the social optimum requires cutting the benefit to depositories to less than EI and setting the GSE benefit at FJ. This may be difficult to accomplish in practice, and the calculations involved in estimating areas inside triangles difficult to pull off. For instance, if it is not possible to cut benefits to depositories, the solution will have to be second best.

IMPLICATIONS OF THE MODELS

Measuring the Size of the Benefit In Model 1 the gross benefit to F and F, the difference between its cost of funds and the purely private market's cost discussed above, is the distance FD. However, the distance FG is not a benefit to them because it is what is necessary for them to compete with the depositories. The net benefit is only GD. The benefit to depositories (gross and net are the same in this example) is the distance EC, which may or may not be bigger than the net benefit to GSEs. The guarantee component of the benefit is less than the gross benefit, but by how much cannot be inferred from the picture.

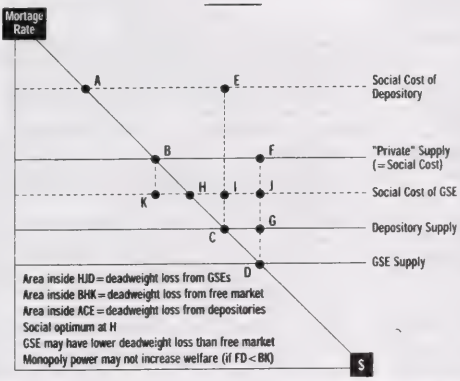
Beneficiaries In its 1996 study, CBO estimated the extent to which GSEs' benefit is passed through to borrowers. One measure comes from dividing the extent to which F and F lower mortgage rates, measured by the difference between conforming and nonconforming rates, by the extent to which their cost of funds is lowered by their charter, which they measure by the gross benefit defined above; another measure is the amount not passed through divided by income. The study estimated that the decline in rates (their estimate was around 35 bp) was only about two thirds of their measure of the gross benefit to GSEs (about 50 bp) and that the retained part constituted about 40 percent of F and F's income. There are two problems with the estimates.

The gross benefit is probably overestimated. As discussed above, the best guess for the difference between GSE actual borrowing rates and those for low AA is more like 20 to 40 (or 50) bp with CBO's 50 bp at the high end of the range. Of course, these numbers are not very precise; it is possible that a statistical test would be unable to reject the hypotheses that the gross benefit equals the conforming-nonconforming spread.

The calculation should use the net benefit, which is the maximum amount that can be passed through. The difference, again, is that some of the gross benefit, FG in the figures, simply cancels out the benefit to depositories, leaving the net benefit at GD. Thus, even in principle the CBO number does not measure how much of what could be passed through actually is passed through. By construction (because I assumed the supply curves allowed for only normal profits), in both Models 1 and 2 all the net benefit is passed through, but both models are also consistent with CBO's calculation that 40 percent is kept.

To the extent the benefit is kept by GSEs in the form of excess profits, it is unlikely that much has gone to current shareholders, because in an efficient market it will have been capitalized into stock price. Current shareholders paid for it when they bought the stock and cannot be expected to earn more than normal returns. The benefits of the GSE charter have already been auctioned off. The distributional effects of F and F are neither very interesting nor very easy to sort out.

Model 2



Effects of the Benefit In Model 1 the welfare effect of the benefit is ambiguous because while on the one hand it extends the subsidy to homeownership and housing, which has a negative effect, the real resources used in producing mortgages are less than with depositories, which provides an offset. In Model 2, where there are externalities, the effects of F and F are more likely to be positive.

Note that the benefit used here pertains only to the benefits that affect incentives *at the margin*. It does not refer to overall charter benefits, which might act like lump sum transfers or taxes (e.g., regulatory costs), and which would certainly affect stock price. Only incentives at the margin affect resource allocation. It is possible for the institutions with lowest charter value to be the ones with the most distortionary incentives; indeed, this is likely if the franchise is worth so little that it induces gambling for resurrection.

General equilibrium (e.g., spillover) effects could affect the results (see "Are Fannie and Fred-

die 'Optimal Mechanisms'?" by Charles Calomiris). One possibility is that F and F crowd out depositories who then move their subsidy into other markets (e.g., business loans). If that were the case, then even if F and F helped lower social costs in mortgage markets, it would be at the expense of increasing costs in other markets. That might have been true when there were deposit rate ceilings and depositories did not have access to the off-balance-sheet activities they have now. In that case they had a more or less fixed supply of funds that was bound to be allocated somewhere. More generally, however, the size of the effect depends on the elasticity of the supply of funds faced by the industry as a whole. For instance, a good approximation now is that depositories face a flat supply of funds, explicitly through deposits, and implicitly through off-balance-sheet activity, in which case they exploit each line of business up to the point where marginal benefits equal marginal costs independently of the other lines. In that case being forced out of one line of business has no effect on other lines.

Another general equilibrium effect is that subsidies are likely to be financed by distortionary taxes, which affect other resources (e.g., the trade-off between work and leisure). If the effect of F and F is to lower the contingent liability faced by the government from deposit insurance, then there is a net benefit from a decrease in distortionary taxation. General equilibrium effects are more likely to come about because of effects on interest rates in general.

Regulatory Choices The welfare aspects of F and F are indeed complicated and need to be considered in the context of their market and the distortions within their market. The above analysis suggests genuine ambiguity about what should be done. For instance, if you cannot change the status of depositories, is it better or worse to cut the benefits to GSEs (or in the limit, privatize them), and are excess profits bad if they diminish risk-taking? So far there has been no significant empirical work that can serve as a guide for public policy.

In lieu of such work I am led to the following line of argument:

> *Congress created GSEs because whatever goal Congress had in mind can be accomplished better by a profit-oriented institution than by a government agency. To induce GSEs to do what they want Congress restricts their charters but also gives them benefits that lead to embedded options and provide incentives that affect prices and resource allocation.*

The benefits of a GSE are supposed to come from the efficiency that comes from maximizing profits by responding to market signals rather than by risk-taking to exploit options. Some conflict is inevitable, particularly if a GSE gets into trouble. Hence, on pure efficiency grounds safety and soundness regulation is needed. The case that embedded options are currently large in value is difficult to make. You cannot simultaneously believe that F and F are earning large monopoly profits year after year and that they are exposing taxpayers to large risks, although you can simultaneously believe that they might expose taxpayers to risks in the future.

The case for regulation to promote competition is weaker. In the first place, if the relevant industry is the mortgage industry as a whole, the conjectured level of competition becomes larger than if the market is assumed to be a duopoly in the secondary market. Second, if F and F distort resource allocation by allocating too much capital to housing, then more competition further distorts resource allocation. Furthermore, monopoly power provides incentives to take less risk in order to keep the franchise. You can worry about competitiveness if you believe Model 2, but then you have to acknowledge GSE benefits. If you want more competition you probably believe that benefits received by GSEs have been socially beneficial.

I have focused on efficiency. For reasons discussed above I see no real equity issue. You cannot believe both that the stock market is efficient and that current shareholders make excess profits systematically.

In summary, I think the main focus of regulation should be on safety and soundness, with an eye on keeping embedded options under control and equal in (net) value across charters. These options are not trivial, and depositories and GSEs have in the past gotten into trouble from them. But for the most part the risks in mortgage markets (mainly interest rate risk and credit risk) are quantifiable and controllable. I think that was the main intention of the 1992 regulatory legislation that established OFHEO and defined mission goals for F and F, and it is consistent with recent approaches to bank regulation, which focus on capital adequacy and controlling risk, rather than micromanaging.

readings

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June 19, 2000

Review & Outlook

Fannie Mae's Problems

Dear Abby,

My brother, Freddie Mac, and I are financial institutions. We are in the mortgage biz. For decades we helped make the market for middle-class home mortgages more liquid. Everything was totally cool and everybody loved us.

And what's not to love? We are madly profitable -- in recent years, our return on equity has averaged 24%, which makes us a lot fatter than other financial institutions. We are also huge -- right now, we own or guarantee almost 80% of all middle-class home mortgages. And we are going to get bigger. In just three years, if I grow at the rate predicted by my CEO, Franklin Raines, I could be one of the largest financial institutions in the world. Plus, if my brother and I keep to his growth predictions, by 2003, according to an estimate by Peter Wallison and Bert Ely for the American Enterprise Institute, we will have taken on mortgage loans worth more than $3 trillion -- that's 90% of all middle-class mortages and 48% of all home mortages in the U.S. Not bad, huh?

To be honest, we are sitting pretty. Even though we are a publicly traded company, we have a special relationship with the federal government. (No, it's not what you're thinking -- it's better!)

Unlike other private financial institutions, we don't have to pay state or local taxes and we don't have to register our securities with the SEC (both of which saved us about $1 billion last year); we have lower capital requirements; and we even have a line of credit with the Treasury Department that other private financial institutions don't have.

But that's not all. This special relationship leads people to assume that ultimately our debt is backed by the full faith and credit of the U.S. So our borrowing costs are really low -- almost as low as the Treasury. The Congressional Budget Office estimates that this subsidy was worth $6.5 billion in 1995. It's probably much more now. Plus, Abby, we don't even have to pass this subsidy on to our customers. In fact, the CBO estimated that we keep $1 for every $2 of it for ourselves. How else could I afford to compensate my CEO almost $18 million in cash, options and performance shares last year? (Amazed? Check my proxy statement.) That subsidy, Abby, accounts for 40% of our profits. Cool, huh?

But here's my problem. We want to grow faster than our market is growing. Actually, we must grow faster if we are to keep our stock from tanking. In just a few years, we will own or have guaranteed almost all the high-quality loans on middle-class homes. I don't want to sound piggy, but we are going to have to elbow our way into other markets, like subprime lending.

I don't think that's such a big deal, but -- yikes! -- you should hear the fuss this has kicked up. Other financial institutions say this isn't fair; they are scared that they can't compete with us because of our special relationship with my uncle. Sure, the playing field isn't level, but is that my fault? Those guys are going to be toast and they know it.

Then there are the economists and policy wonks. They are scared of the risk we are taking in moving into other markets; they are afraid that we won't properly hedge our risks. And to be perfectly honest, why should we? It would raise our costs and reduce our profitability. Duh.

Of course it's true that the greater the risk, the greater the chance we'll go belly-up -- you remember the thrift crisis of the 1980s -- but what could be more American than a taxpayer bailout? So what if it could cost more than $3 trillion and make the thrift bailout look like peanuts? Actually, Abby, we are living the American dream here -- public risk and private profits.

Some economists are saying that we aren't necessary anymore because private lenders have made the mortgage market plenty liquid and efficient. Some even point out that we don't really benefit mortgage borrowers because lower mortgage costs are just capitalized into higher home prices. I tell you, Abby, it was almost the last straw when Alan Greenspan started blabbing it around that our subsidies are ultimately either financed by taxpayers or borne by everybody in the form of reduced wealth.

Anyway, there's a whole list of dudes who are mad as spit with us -- even people like Martin Luther King III and my boss at HUD, Andrew Cuomo, are complaining that we aren't doing as much as private lenders to help minority homebuyers.

We are fighting back. We advertise, we contribute to political campaigns, we donate money to politically correct charities. And we are lobbying like crazy. Like when Congressman Richard H. Baker (R., La.) introduced a bill this year to sever our line of credit at Treasury. Well, we hired a phone bank company to call thousands of people to get them to agree to our sending out letters on their behalf to their Congresspeople. (Unfortunately, it turned out that many of the people whose names we used had no idea what we were up to. This really irritated some of the Congresspeople who got our letters.)

So, you see, Abby, we could really use some advice here.

Fannie Mae
Washington, D.C.

Dear Fannie Mae,

Shame on you! Such a lot of whining. Why not just give up your "special relationship" with the government and privatize, privatize, privatize? It's not ladylike to outstay your welcome.

Reverend Graylan Scott Hagler, Senior Minister
Plymouth Congregational United Church Of Christ
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Washington, D.C. 20011
202-723-5330

Statement To The Capital Markets Subcommittee Of The Committee On Banking And Financial Services

June 21, 2000

Today, I want to focus a little on Fannie Mae. There is a frightening dimension to Fannie Mae, and I say this after witnessing Fannie Mae's heavy handed techniques in shaping public opinion, and even causing advocacy groups to acquiesce to the power and influences of this publicly traded government sponsored enterprise.

For the last two or so years, I have watched and participated as Fannie Mae and Freddie Mac hosted numerous gatherings, which means, financially underwriting those conferences and many conferees, under the auspices of groups like the Civil Rights Leadership Conference, the National Community Reinvestment Coalition, and the Neighborhood Reinvestment Corporation. I watched as Fannie Mae and Freddie Mac peddled their desire to engage in sub-prime lending, taking the position that some people will never qualify for prime lending, but still needed to be serviced, and that they were the ones who were able to attend to this under-served market. At face value one will not necessarily see the problem with an arrangement of this kind. After all, conferences should be an environment where ideas are allowed to flow, disagreements surface, and strategies for addressing problems gel. Unfortunately, I have found that these conferences are usually not the place for this type of interaction and development. Instead, the purpose of the gathering is clear, particularly when they are underwritten by Freddie or Fannie, and that is to buy submissive loyalty with silent approval to the actions of the GSEs.

An example of this occurred nearly three years ago. While participating in a conference on community lending sponsored by a non-profit organization, and partially underwritten by Fannie Mae, I, along with some colleagues challenged Mr. Johnson, then CEO of Fannie Mae, about his stance on the issue of "zero

down" lending. Approximately a week after challenging Mr. Johnson I received a note from the Executive Director of that non-profit corporation saying, "Fannie Mae has canceled an $80,000 grant with us. Are you happy?" The note was in direct reference to the questioning that the CEO of Fannie Mae was exposed to during this session in the conference.

Another glaring example of Fannie Mae's ability to shape public opinion took place during the recent serious financial crisis that we faced in the District of Columbia. I was engaged in educating the public with other clergy around the issue of Fannie Mae's exemption from taxes while enjoying a prominent and profitable presence in D.C.. We educated the public and pressed Fannie Mae in hopes of recouping some share of revenue that is protected from taxation. It seemed to be only fair since District roads, water, police and fire services helped to facilitate this profit making shareholder owned government sponsored enterprise. However, gradually one minister after another dropped out of the work of the coalition with each quietly citing that they had received money from Fannie Mae for one project or another, and therefore their speaking, acting or organizing would no longer be prudent. Though this advocacy didn't bring any new monies into the District, evidently for the price of silence and inactivity some groups received funds that may not have otherwise been made available.

These two examples, I believe, are important ones, because corporations like Freddie and Fannie, which enjoy special benefits and subsidies by being GSEs, should not be engaged with the public in ways that quiet protest, mute questions, or dispirit spirited debate. However the very size and money of these GSEs has leaned toward this tendency. And when so much is spend on public relations, "Showing America The Way Home", there is a natural resolve to silence anything that threatens to tarnish the hype.

It is clear to me that these GSEs need more scrutiny and accountability. Being a type of hybrid, both a shareholder owned corporation and yet enjoying generous government subsidy, these GSEs sometimes get caught up in their own spin. On the one hand, they seek and claim to do good, making monies available for home ownership and attempting to come up with strategies to help larger segments of the American population achieve that dream. Yet at the same time, these GSEs are responsible to shareholders in maximizing return on investment. I believe this is one of the motives that have led Freddie and Fannie to enter the sub-prime market. Of course, Fannie and Freddie publicly claim that by entering those markets they will have the ability to regulate it through the flow of their

dollars and product into the arena. However, the real reason can probably more accurately be found in higher interest rates, greater fees, prepayment prohibitions, and greater profits to the corporation and its shareholders. A friend of mine once told me that "de-nial" is more than just a river in Egypt!"

Of course the real fear here is that when the economy goes south, or just through one of those cycles that it periodically goes through, if Fannie and Freddie are engaged in these sub-prime markets then they will get left holding the bag, and the American taxpayer with them. If Fannie and Freddie are protected by their great ability to buy silence, then who is going to protect Joe and Jane Taxpayer from the imprudent moves that come when one is above questions and fair criticism like it seems that Freddie, and particularly, Fannie Mae is.

It has been suggested by previous witnesses last week that these GSEs should be setting the standard for what is offered in the market place. They should not be following the market downward into exploitation and predatory lending, but should be leading the market upward to new places of social responsibility. I concur with a previous witness, that these GSEs should be monitored and evaluated according to a well founded criteria of social responsibility, meaning: what communities have been helped by these enterprises; what families; precisely where; what income levels; and how has these enterprises made a difference in particularly under and unserved communities.

Also, it is dangerous, frightening and undemocratic that GSEs, like Fannie Mae, while receiving millions of dollars in government subsidy, uses millions of dollars to lobby congress, fund political campaigns and silence critics. This is an unfair and unintended advantage of these GSEs, and should be corrected. It further protects the GSEs from scrutiny and even regulatory inquiry, because they have the right and financial might to politically lobby and silence any critic they choose.

My name is Bruce Marks. I am Chief Executive Officer of the Neighborhood Assistance Corporation of America (NACA), a non-profit housing services and advocacy organization. NACA is known for its "Best in America" mortgage program which offers low and moderate income Americans home mortgages with low interest rates, no down payment, and no closing costs. Perfect credit is not required.

Through the NACA program thousands of Americans have realized the dream of home ownership. NACA provides prime loans for "sub-prime borrowers." NACA has 21 offices across the country with $3.8 Billion committed to the best mortgage in America. The current interest rate for NACA mortgages is 7.5% fixed for 30 years with no down payment, no closing costs, and no fees. In addition, NACA provides comprehensive housing services at no cost to the borrower. It may sound too good to be true but it is the reality for thousands of working people. People can call NACA at 1-888-302-NACA to participate in this incredible program.

NACA is also known for its advocacy campaigns against predatory lenders. As the committee is no doubt aware, there are predatory lending companies out there who use misleading sales tactics to take advantage of those who, through little or no fault of their own, have been excluded from mainstream credit institutions. NACA has worked in the street, in boardrooms, in statehouses, and in this building to fight these exploitive lending practices with a great deal of success. However, despite our efforts, these practices continue.

Mr. Chairman, you are absolutely correct in focusing your attention on the GSE's and in particular Fannie Mae. With over a Trillion dollars in assets, they set the standards in this country for access to home ownership for working people. For too long there has been virtually no scrutiny of the GSE's. As you know, the GSE's determine what is a conventional loan and what is considered a sub-prime loan. A conventional loan is considered to be one that meets Fannie Mae's criteria and is known as a Fannie Mae loan. Non Fannie Mae loans are considered sub-prime loans and have become synonymous in the minds of many as predatory loans. The GSE's are market makers. All the billions of dollars the government spends on housing programs pale in comparison to the impact the GSE's can have on home ownership opportunities. This is particularly true for low and moderate income families.

There is no question that at one time the GSE's provided an important function. They provided liquidity to mortgage lending and standardized mortgage lending. They now need to declare victory and compete on the same level as other non-government entities. The GSE's have provided an extraordinary return for their stockholders but have failed in their mission of providing affordable mortgage access to low and moderate income people.

It is ironic but true that the private sector, with no government subsidy or support, is providing good, affordable loans to working people who the GSE's refuse to lend to. While there are numerous examples, we want to highlight a particular case, Lawrence Massachusetts.

In the early 1990's, Lawrence was going through tough economic times. Arson for profit was prevalent and only a limited base for home ownership existed. However, beginning in I995, NACA began providing home mortgages to the hard working people of Lawrence. Many of these borrowers worked two and three jobs and always paid their rent on time. NACA felt that people's intense desire for home ownership would provide the foundation to revitalize Lawrence. NACA offered families a mortgage with no down payment, no closing costs, no application fees, at a below market rate. They did not need perfect credit to participate in NACA's program. Over the next six years NACA enabled 600 families to buy their own homes in neighborhoods all over Lawrence. This map identifies the homeowners. While people were able to purchase beautiful homes that required no renovation for less than $30,000 in I995, today homes in the same area sell for over $125,000 and additional funds are required to make necessary repairs in this tight market.

Lawrence is now a revitalized community. Hundreds of NACA homeowners have taken back the neighborhoods from gangs, drugs and violence. Malden Mills, the region's major employer, which received national media attention as a model of corporate responsibility after a massive fire destroyed most of its operations, has now been rebuilt and is extraordinarily successful.

The question is – Where was Fannie Mae? Fannie Mae determined that Lawrence was a "declining value community". They would not purchase loans made to working people in Lawrence regardless of their income, credit, assets,

etc. Fannie Mae redlined Lawrence and many other communities. Major private lenders stepped up, but this GSE, whose mission is to make home ownership possible put out the notice, "Lawrence is off limits".

NACA stepped in where Fannie Mae, the GSE, chose not to. Look at the results: of 583 loans that NACA has provided over five years there have been only two foreclosures. Currently there are 13 delinquencies, 8 of which are only 30 days late. These results speak for themselves, demonstrating that, given the opportunity, working people that are provided prime loans to purchase their homes will become the bedrock that every strong neighborhood needs.

NACA provides Prime loans for subprime borrowers. The NACA home owners in Lawrence are typical of the thousands of home owners in the NACA program. Over 65% of NACA home owners have a FICA score of less than 620 and almost half have a score of less than 580. Fannie Mae considers borrowers with FICA scores less the 620 to be too risky. In addition, 75% of NACA home owners have less than $4,000 in assets, 37% are single head of households, and the vast majority are the first generation of home owners in their families. They are stabilizing communities nationwide.

The GSE's have learned from this experience and are working to extort profit from these borrowers. The GSE's understand that the working people participating in the NACA program do not have perfect credit but pay their mortgage and do whatever it takes to pay their mortgage. The GSE's now want to lend on a massive scale to working people who have good but not perfect

credit. But, instead of recognizing the commitment and credit worthiness of working people, they want to exploit them with sub-prime loans.

Sub-prime lending or as it used to be referred to "LOANSHARKING" has always been a part of the economy. In the past we had local institutions that understood the credit realities of working people and provided them with conventional affordable loans (i.e. Savings and Loans, Thrifts, local banks, and credit unions). People who had severe financial difficulties went to the loansharks who would "lend" on outrageous terms for a short period of time. The borrowers understood that the loan must be paid. They sacrificed everything to pay it off. But after this short-term period most were able to move themselves and their families forward (a few did not move at all).

The subprime industry began as a means to provide short-term financing to those with major financial difficulties. It was not there for good credit borrowers nor was it meant to devastate the finances and lives of hard working people. This, however, is exactly what this sub-prime industry has become.

The GSE's have created this $300 Billion sub-prime market and now want to profit from it. The vast majority of sub-prime borrowers are considered A- or B+ borrowers. They are hard working people who should absolutely meet the criteria of a conventional borrower. They may not have substantial savings, but they always pay their rent and mortgage. The GSE's want to make 100 to 200 basis points (one or two percent) on these borrowers who should be treated as the best and most reliable borrowers. In the mortgage business this is a huge spread. It is insulting and worse to call these borrowers sub-prime. The GSE's

pay brokers thousands of dollars to originate these loans and make it worse by encouraging pre-payment penalties and other terms that further exploit the borrowers.

Predatory lending has become a major national issue as it should. NACA has been in the forefront of taking on predatory lenders and was instrumental in passage of HOEPA. The focus at that time was Fleet Finance. When NACA had over 500 Fleet borrowers from around the country participate at the Senate Banking committee, Senators from both parties pushed through this legislation. Everyone understood that it did not solve the problem but was a first step. NACA has continued the fight against these predatory lenders. However, once one is defeated others will appear like roaches until the market and profit for these loans is substantially reduced.

GSE's, which are subsidized by the American taxpayer, are the major cause of predatory lending. If the majority of the sub-prime loans are correctly evaluated as conventional, the abuses will be dramatically reduced. But the GSE's will not do so because there is too much money in it for them. Why lend to a family at 8% when you can get 9%, 10% or more? The most galling aspect is that the GSE's charter calls for lending to low and moderate income buyers not exploit them.

As has been clearly documented by HUD and other testimony, the GSE's fund a lower percent of loans to low and moderate the people than to upper income borrowers. For example in l997, the GSE's purchased 39% of all owner-occupied and rental property available during the year while it purchased only

30% of the units purchased by low and moderate income families. It is an outrage that Fannie Mae and Freddie Mac, with over $10 Billion in subsidies, do less for working people than the for-profit lenders. Their public relations prowess and utilization of their financial resources to squelch dissent is legendary. There is so little fact and substance to their commitments to lend to working people that it is almost incomprehensible. NACA has offices in one-third of the areas where Fannie Mae has Partnership offices . NACA provides hundreds of mortgages with excellent results in each of these cities to working people who Fannie Mae deems too risky. All the while Fannie Mae officials work their public relations machine. The GSE's will not reform without Congressional action.

H.R. 3703 would not in itself stop all of the inequities created by Fannie Mae's underwriting system. It would, however, point us in the right direction. The creation of a Housing Finance Oversight Board that would be both interdepartmental and bipartisan would mean that there would be, for the first time since privatization, meaningful oversight of Fannie Mae and the other GSEs. This oversight would be particularly significant since the legislation also requires public disclosure of information by each enterprise as the Board deems necessary. While the H.R. 3703 does not specify what information each enterprise will need to disclose, one would hope that such information would include the salaries of each enterprise's directors and officers, the amount of money spent on public relations, lobbying, and campaign contributions, and the

extent to which the support provided by these enterprises is actually used to help those in need of it.

It is hard to understand why GSEs, which were created with government funding and have continually relied on government subsidies, oppose having to reveal information to the government about what they do with their money. It is also ironic since non-government supported entities subject to the recently passed Sunshine Act are forced to disclose extensive information to the government merely because they may have once discussed the CRA with a bank they have a relationship with.

H.R. 3703's requirement of prior board approval of new activities is also significant and something that advocates of fair housing should get behind. Without such controls Fannie Mae will continue to expand its reach into the subprime market and might itself become a predatory lender. The committee would also be in a position to control the GSE's participation in potentially profitable but also potentially risky investments schemes. Participation in these schemes by GSEs pose potential risks for the housing and banking industry and for the economy in general.

Of particular significance is the bill's effort to cut treasury department guarantees and other subsidies to Fannie Mae. As prior testimony has shown, Fannie Mae and Freddie Mac received a subsidy of 10 billion from the federal government of which 3.5 billion was for the benefit of stockholders and management. Government created and has supported Fannie Mae, Freddie Mac, and the other entities in order to bring stability to the secondary mortgage

market and make it possible for ordinary Americans to own a home, not to enrich their executives and bondholders.

This deviation from the mission brings me to my final point. While there are many provisions of H.R. 3703 that NACA supports and maybe some parts with which we do not, it seems that the bill's central thrust is to make Fannie Mae and the other GSE's accountable to the American working people whose taxes brought them into being in the first place. Fannie Mae is a government entity when it needs something from the government but a private corporation beholden only to its bondholders when it is asked to be accountable. This is corporate welfare at its worst. The American taxpayer is providing billions of dollars to private government chartered institutions that are exploiting and profiting from the intense desire of working people for home ownership. This situation needs to be changed and this bill is the first step.

I would like to thank the Chairman and the committee for inviting me.

Statement of the Honorable Walter E. Fauntroy

Before the House Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises

June 21, 2000

Chairman Baker and members of the committee. Let me first thank you for the opportunity you have given me to return to lay out in greater detail the views that I was only able to summarize at your hearing last week. I appear before you in three capacities today. The first is as president of the National Black Leadership Roundtable, the national network vehicle of the Congressional Black Caucus. Composed of the heads of more than 200 national black organizations in eighteen categories of American life, the Roundtable convenes twice a year to determine how best to support a CBC public policy agenda designed to improve the quality of life for African American citizens in the broad categories of (1) income generation, (2) education, (3) health care, (4) housing and (5) justice. For guidance on matters of housing and community development, we rely heavily upon two of our members who are out there where the rubber hits the road on the question of affordable housing: the National Black Caucus of State Legislators, the National Conference of Black Mayors and its parent body, the World Conference of Mayors.

With your permission, I'd like to enter into the record at this point, letters sent me on the subject of H.R. 3703 by State Representative James L. Thomas, President of the National Black Caucus of State Legislators, and The Honorable Johnny Ford, founder and director of the World Conference of Mayors. These letters state their support of Fannie Mae's efforts to remove remaining barriers to homeownership and to bring even more families closer to the realization of the American Dream. They also oppose H.R. 3703 because it would "impeded future progress" of increasing homeownership in this country.

Secondly, Mr. Chairman, I testify here today against the background of the nearly twenty years that I spend as a member of this committee, six of them as chair of the subcommittee on Domestic Monetary Policy and four of them as chair of what we called the subcommittee on International Development, Finance, Trade and Monetary Policy. And third, Mr. Chairman, I testify against the background of more than forty years as an inner-city pastor, civil rights activist and community organizer who, in the 1960's and 1970's, developed and implemented a national demonstration project aimed at housing low and moderate income citizens here in our nation's capital that enjoyed the enthusiastic support of both President Lyndon Johnson and President Richard Nixon.

There are two reasons that I have asked to appear before a House Banking subcommittee for the first time since I left the congress in 1991. The first is my great appreciation for what this committee did in 1992 in passing the Act that modified Fannie Mae and Freddie Mac's charter. That 1992 Act was long over due and one for which I had longed for years. It created the GSEs' affordable housing goals, strengthened HUD's role as the GSEs' mission regulator, and created a system and a regulator for ensuring these companies continued to be financially safe and sound. The second reason is that, as quiet as it is kept, we have a greater need today for our GSEs' to carry out the mission given them than at any time since they were first chartered. That's because of a single disturbing trend in the nation that reflects itself most acutely right here in our nation's capital. Despite the booming economy, worst case housing needs are more severe across the nation today than ever.

THE DEEPENING CRISIS

Let me remind you of what HUD had to say to you in its most recent Report to Congress on

Worst Case Housing Needs, published in March of this year. It informed you that worst-case housing needs reached an all-time high of 5.4 million households and that there are now 600,000 more worst case households today than there were in 1991 when the current economic recovery began – a rate of increase that is almost twice as fast as overall household growth. Nowhere is this deepening crisis more acutely reflected than right here in our nation's capital. In the last two years, our Section 8 waiting list in the District has increased by 29%, our public housing waiting list by 24%. Time on our waiting lists for both Section 8 and public housing is up to five (5) years. The national average for waiting time is eleven months.

This situation here and across the country would have been worse had you not passed the 1992 Act and had not Fannie Mae and Freddie Mac responded to the directive that HUD, in its new regulatory role, gave them to devote 50% of their business to the service of low- and moderate-income families. Members of congress cannot dismiss the fact that in communities across the country, including the District of Columbia, these mission-driven companies have helped harness private capital and direct it toward fulfillment of the American dream of homeownership. Let's look at some of the facts:

- Today, our national homeownership rate stands at an historic high of 67%. A little closer to home, here in DC, the homeownership has risen to 42%. While that needs to be a lot higher, it sure represents a lot of progress.

- Minority homeownership during the 1990s grew tremendously. That's not to say that much doesn't remain to be done on minority homeownership. The African-American homeownership rate today is over 47% (up from 42% in 1993), and the Hispanic homeownership rate is close to 46% (up from 39% in 1993) -- but the white homeownership rate is over 73%.

- In 1993, Fannie Mae served 35.6% of families with low- and moderate-income. Today, under goals set by HUD, 50% of Fannie Mae and Freddie Mac's business must serve low- and moderate-income families, and I will be watching to make sure that they really do meet this goal.

It is clear that our GSEs are part of the answer to narrowing the homeownership gap and raising the rate of minority homeowners. These are significant results, and these are results that should not be taken lightly or dismissed. Any effort to reform or change the current structure and the role of Fannie Mae and Freddie Mac must, in my view, look at the huge benefits these companies provide to Americans, and the costs "reforms" would mean to homeowners. Because there aren't as many people in the African American community who own houses, my community would be hit the hardest.

In light of the deepening crisis in affordable housing for low and moderate income families that is upon us, we do not need to stifle the progress that our GSEs' are belatedly making on the mission for which they were chartered. We need, rather, to challenge them further to enhance the tools at their disposal to serve those segments of our society that the so-called "private market", left to its own devices, will not serve; -- segments where it is perceived that the risks are too high and the returns too low. We need to challenge our GSEs' to do more to clean up the "predatory loan" market for second mortgages. They need to come up with even more creative ways of making home ownership available to senior citizens on limited incomes and moving more credit worthy low and moderate income loan applicants from "C" to "B" to "A" ratings where those moves are warranted. And once they become homeowners, our GSE's need to facilitate access to affordable, non-predatory home improvement loans such as they are now beginning to do.

CRITICISMS THAT HAVE NO BASIS IN FACT

I would like to take a moment to challenge some of the points made by critics of the GSEs. There are those who assert that the GSEs should no longer exist -- that whatever market

failure they were originally created to address has been remedied, and that the "private market", without the GSEs, can fully meet the housing finance needs of our country. I don't believe that for a moment, Mr. Chairman. There is a reason why Congress -- why this Committee -- has seen the need to enact laws like the Community Reinvestment Act. It is precisely because this so-called "private market", left to its own devices, will not serve certain segments of our communities -- segments where it is perceived that the risks are too high and the returns too low. This is not to say that everyone can and should be a homeowner -- it is just that Congress has determined that it is appropriate to create additional incentives and structures to push the market to do more and to recognize the business opportunities of non-traditional markets.

To dramatically change or "privatize" Fannie Mae and Freddie Mac would mean that the underserved would be even more underserved. That would keep many people in my community out of houses – and that is bad. Homeownership strengthens our communities. That is a fact. How can we ever hope to solve many of the social and economic problems facing low-income and African American communities if we take away the opportunity for them to become homeowners? Our society and Congress have determined that homeownership is good – and Congress had created additional incentives and structures to push the market to do more. Just like the housing tax credit, the GSEs are an important part of our nation's policies designed to promote and encourage homeownership.

I've heard complaints about Fannie Mae and "mission creep" – but Fannie and Freddie are just trying to do the job Congress gave them. For example, critics say home equity loans are "mission creep." That is not "mission creep" -- home equity loans are an IMPORTANT part of Fannie and Freddie's mission. Today's fancy term "home equity loan" was and is a second mortgage. At least that's what we called it in 1984, when I was here and this committee explicitly added second loans or home equity loans, to the list of products we **wanted** Fannie Mae to buy. We did this because it meant that second mortgages would come down in price. Having Fannie and Freddie in this market helps lower consumer prices for those products. That's good!

Other critics say Fannie Mae and Freddie Mac are risky. This claim is ridiculous. Fannie and Freddie are the best risk managers on the planet. Their credit losses low— and they also have a great record of helping their lenders work with borrowers who are in trouble. That means that their lenders forbear on delinquent loans and develop workout plans. That's why Fannie and Freddie's losses are so low -- they know how to manage risk up front and they know how to manage risk when the going gets tough. And this good work helps keeps people in their houses, which helps keep a community strong.

Business competitors who get just as many government benefits as Fannie and Freddie are bringing many of the complaints about Fannie and Freddie's government benefits. As Chairmen Volcker and Greenspan taught me, these banks have access to cheaper working capital because of federal deposit insurance (for which they do not pay), access to the federal home loan bank advance system, and the advantages of the Federal Reserve System—but these banks try to call themselves "private" while claiming that Fannie and Freddie are part of the government. If Fannie and Freddie have, as some believe, an "implicit benefit from the government," which even CBO claims is largely passed onto consumers, how much of the very real bank subsidy Mr. Greenspan talked about gets passed on?? I suspect very little, Mr. Chairman. But, that would be an interesting question for the Congressional Budget Office to answer.

I get the feeling that this bill represents a wish list of people who don't like Fannie Mae and Freddie Mac for competitive reasons and only want to drive them out of business so they can lea into their place and charge those about whom I'm most concerned a lot more a lot less of a loan.

Some have challenged, for example, Fannie Mae and Freddie Mac's entry into the subprime

market. But being in the subprime market means Fannie and Freddie can help fight predatory lending. Predatory lending is very bad. It is destroying many people in the communities I work with – and it must be stopped. Fannie Mae and Freddie Mac will help be a solution to the predatory lending problem. We need them there to help. These companies were the first to speak out against this problem – and we need their leadership. Most of the complaints about Fannie and Freddie entering the subprime markets are not coming from regulatory authorities--HUD wants them to go there—but from the predatory lending companies who have been overcharging millions of American families, especially minority and low-income families.

Simply put, Mr. Chairman, this proposed bill would raise the costs of homeownership. These are costs that already are too high for many people in our minority communities.

Fannie Mae's Exemption From State Taxes

Let me say a word as well about this matter of Fannie Mae's exemption from state taxes. As you know, Congress chartered Fannie Mae, Freddie Mac, and the Federal Home Loan Banks to lower the cost of homeownership in all 50 states, to smooth out regional imbalances in mortgage supply, and to integrate regional mortgage markets into the national capital markets. By creating a liquid secondary market for mortgages in all 50 states, Fannie Mae also lowers the exposure of banks and swifts to regional downturns.

Congress exempted Fannie Mae from taxation by the states, not as a subsidy, but to help the GSEs' fulfill their mission in all 50 states. Fannie Mae's Congressional charter requires the company to pay Federal income taxes and **local property taxes** but exempts the company from paying state income taxes for a very good reason. Without the exemption, one or more states might attempt to overtax the company, and Fannie Mae's charter would prevent it from attempting to leave the state – which is how other private corporations respond to state's attempts to overtax their income. With its bargaining power hobbled by it charter, Fannie Mae might be forced to pay state tax on more that 100% of its income if its exemption were withdrawn.

To avoid that unfair result, Congress had the choice of either exempting Fannie Mae from state income taxes, or inserting itself into the fair apportionment of Fannie Mae income among the 50 states. Congress wisely chose the former course, and demonstrated that this was a policy decision, not a subsidy, by allowing the states to tax Fannie Mae's real property (which does not create the difficulty and ongoing apportionment problems). Rescinding the exemption would in effect impose a national housing tax, as Fannie Mae would be required to pay hundreds of millions of dollars annually in taxes on business it does throughout the country. These expenses would be passed to consumers in the form of higher mortgage rates.

D,C. Taxes

As the District of Columbia's first elected Delegate to the U.S. Congress, author and enabler of the Home Rule Charter that was suspended by the Congress in 1995, and as an ardent advocate of self determination here and around the world, I must say a word about the proposal to impose a state tax on Fannie Mae income here in the District of Columbia. Fannie Mae, of course, while exempt from paying local and state ***income*** taxes, does pay 100% of its share of local ***property*** taxes here in the District of Columbia and in all other states.. In fact, I understand, the company paid more than $2.4 million in local property taxes here last year.

I have steadfastly maintained over the years that the District of Columbia, whose residents are treated like a state for taxation purposes, should be treated as a state in all respects: voting representation in both houses of congress, the right to impose a tax on the income of non-residents as do other states, and the right to payment in lieu of taxes from the Federal government in light of the fact that 55% of the taxable land in the district is taken off tax rolls due to federally mandated exemptions. We want no more, and no less than the same

privileges and the same responsibilities every other American has. Since Congress granted Fannie Mae an exemption from local and state income taxes in order to assist the company in its mission to make home mortgages more affordable and available to families of modest means in every state and territory of this country, I do not want an exception to that rule for us for the reasons cited above.

Since the low and moderate income families of the District have a greater need per capita for a whole variety of the GSE's services and mortgage lending programs than any state in the Union, I do want to see them commit substantially more of their resources to serving the affordable housing needs low and moderate income families in the country generally and in the District of Columbia in particular.

That is precisely why, even as I oppose further consideration of H.R. 3703 by the subcommittee, I have proposed a better course of action. I have proposed that members of the subcommittee join ranking member Paul Kanjorski and me on a bipartisan basis in an exciting national demonstration that is about to commence at the request of a faith-based organization that it is my privilege to head. It is a partnership made possible by your passage in 1998 of the **Asset Control Area Partnership Act** which creates a new way of revitalizing neighborhoods, one that creates decent housing through federal/local govern partnerships with faith-based institutions to efficiently dispose of HUD-owned single family homes.

The **F**und for **A**ffordable **I**nnercity **T**urnkey **H**ousing (FAITH), which I chair, has proposed a Neighborhood Revitalization Partnership anchored by HUD that includes the District Government, Fannie Mae, Freddie Mac and Bank of America among other banks in the District of Columbia to buy, rehabilitate and sell to qualified low/moderate income homeowners all of the HUD owned and District owned single and multi-family family homes located in D.C. As an instructive example to the rest of the nation, we intend to integrate and concentrate all available federal and district government housing programs into a comprehensive approach to solving the present crisis called to our attention by HUD this year. With your help, I believe it will be even more successful than the magnificent bipartisan effort put together by Presidents Johnson and Nixon thirty years ago.

Committee on Banking and Financial Services
Capital Markets Subcommittee
Hearing on
Improving Regulation of Housing GSEs

June 15, 2000

Statement by
Andrew F. Quinlan, Executive Director
CapitolWatch

CapitolWatch is thankful for the opportunity to issue this statement on behalf of its 250,000 supporters on the topic of housing government-sponsored enterprises (GSEs) – specifically the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). CapitolWatch is an avid defender of American taxpayers concerned about the potential risk that housing GSEs' present to the American economy. CapitolWatch is particularly concerned that the risks associated with the housing GSEs are without benefit to the American taxpayers, as Fannie Mae and Freddie Mac have outlived their usefulness.

Is There Still a Reason for GSEs?

Congress created Fannie Mae at the height of the Great Depression in 1938 and transformed it into a quasi-governmental entity in 1968 – two years before it created Freddie Mac. Fannie Mae and Freddie Mac were both created in response to concerns that financial markets were incapable of providing enough liquidity for home mortgages. The housing GSEs would accomplish this by acquiring mortgages from local lenders.

In order to facilitate Fannie Mae and Freddie Mac's investments, the law provided them with several advantages over traditional financial institutions. Congress allowed these two GSEs a line of credit backed by the U.S. Treasury. Fannie Mae and Freddie Mac also have a much lower requirement than private banks for the amount of capital that they must have for each dollar that they lend. Fannie Mae and Freddie Mac have a capital margin of 2% of assets while commercial banks have a capital margin of 8% of assets.

Moreover, Fannie Mae and Freddie Mac are exempt from Securities and Exchange Commission (SEC) registration, as well as state and local taxes. Economists have estimated the SEC exemption alone to be worth $280 million a year. The Government Accounting Office estimated the tax exemptions to be worth $690 million. Furthermore, according to a 1995 estimate by the Congressional Budget Office, the government subsidies that Fannie Mae and Freddie Mac received were worth $6.5 billion.

In addition to the incredible tax advantages, Fannie Mae and Freddie Mac also have the implicit advantage that no private lending institution has: the belief by the financial markets that the federal government will guarantee debt or securities issued by Fannie Mae and Freddie Mac.

Yet, despite all these competitive advantages that Fannie Mae and Freddie Mac receive when competing in the commercial lending markets, Fannie Mae and Freddie Mac purchase only 38% of the total residential mortgage market. Thus, the private lending market is purchasing the majority of loans, even the "riskiest" types of mortgages. As recent reports have shown, the GSEs' purchases of loans to African Americans and Hispanics have not kept pace with the rate at which lenders are originating these loans.

If the commercial lending markets are accomplishing the mission of Fannie Mae and Freddie Mac, why do we still need them? Federal Reserve Chairman Alan Greenspan reached a similar conclusion when he wrote to Congress that these institutions have long since accomplished their goals and that now "these organizations alter the housing financing markets only to the degree that they pass through to homebuyers part of their government subsidy [expense]." Greenspan further commented that the benefits the government extends to these institutions, "are, of necessity, at the expense of other federal or private-sector initiatives and hence are ultimately financed by households, either through taxes or through reduced accumulation of wealth." Thus, Fannie Mae and Freddie Mac have little effect on the secondary housing market but do hurt taxpayers, including those buying houses with a mortgage.

GSEs – The Next and Bigger S&Ls

While any remaining benefits garnered from Fannie Mae and Freddie Mac's unique quasi-governmental status are questionable at best, there are numerous risks associated with the government's relationship with Fannie Mae and Freddie Mac. There is a rapidly growing debt at Fannie Mae and Freddie Mac that is a liability to the American people. The belief by the financial markets that the federal government will guarantee debt or securities issued by a Fannie Mae and Freddie Mac, coupled with a Treasury-backed line of credit of $2.5 billion means that the American taxpayer would almost certainly pay for any Fannie Mae or Freddie Mac debt if they failed.

If either Fannie Mae or Freddie Mac fails, the entire financial system would be jeopardized, similar to the Savings and Loans (S&L) crisis of the 1980s. When the S&Ls could not meet their obligations, the American taxpayers were left with the bill. Currently, Fannie Mae and Freddie Mac hold more mortgage risk than the entire S&L industry. It is clear that Fannie Mae and Freddie Mac are becoming "too big to fail." For if they fail, the real failure will occur in the pocketbooks of every American taxpayer. We must act now to assure that another S&L-type disaster does not take its toll on Americans.

Moreover, the potential failure of Fannie Mae and Freddie Mac would be a cataclysmic event on a much greater magnitude than the S&L failure of the 1980s. Banks now hold $355 billion of mortgage-backed securities (MBSs) guaranteed by Fannie Mae and Freddie Mac. This number represents a huge increase in bank capital susceptible to risk, now over one-third of total bank capital. Private institutions have acquired so many Fannie Mae and Freddie Mac securities that they now hold 75% more Fannie Mae and Freddie Mac debt than their holdings of Treasury securities. If Fannie Mae or Freddie Mac fails, the banks that hold Fannie Mae or Freddie Mac debt will be jeopardized as well.

Conclusion

While the potential cost of a failure to the American economy of Fannie Mae or Freddie Mac is great, the current benefit to the American taxpayer is minimal. The private lending markets are doing Fannie Mae and Freddie Mac's jobs without the huge taxpayer funded subsidies and dangerous advantages that Fannie Mae and Freddie Mac possess. Furthermore, the private lending markets are even doing a better job investing in the "riskiest" of home loans, thus making liquidity of the market a non-issue. Thus, if Fannie Mae and Freddie Mac -- while costing a great deal, both in current terms and in potential risk -- are no longer providing a unique benefit, why do we need them anymore? CapitolWatch hopes that this Committee and all of Congress will stop forcing the taxpayers to subsidize Fannie Mae and Freddie Mac's precarious activities. Fannie Mae was created to help end the Great Depression, let's hope that Fannie Mae and Freddie Mac don't cause the next depression by sticking the taxpayers and banks with their bills.

APPENDIX

July 20, 2000

CURRENCY

Subcommittee on Capital Markets, Securities and Government Sponsore Enterprises

Richard H. Baker, Chairman

For Immediate Release:
Thursday, July 20, 2000

Contact: Mike Diresto (20
or Brookly McLaughlin (20

Opening Statement
Richard H. Baker, Chairman
House Banking Subcommittee
Capital Markets, Securities and Government Sponsored Enterprises
"The Housing Finance Regulatory Improvement Act"
July 20, 2000

America's home mortgage finance system is the envy of the world, and Fannie Mae and Freddie Mac have played a significant role in its success. I think everyone in this room agrees with that ... so let's move on to areas in which we speak in somewhat less uniformity.

When I first began my study of the GSEs several years ago I was confronted with the question of what would happen if one of these enterprises ever experienced a downturn. It was not a pleasant thought -- which is probably why no one seems to have an answer. By the beginning of this year, when I introduced my bill, my one goal was to see if it might serve as a springboard -- that there might be established some sense that it was appropriate to discuss and consider reform in regard to issues of systemic risk, GSE status and mission, and regulatory oversight.

This goal, I think all would agree, has been more than accomplished already. In fact it was accomplished at the first hearing, I believe, when the Treasury testified that the bill has provided Congress "a valuable service by thinking through the best framework of supervision and regulation of these enterprises."

In that first hearing we heard balanced testimony from the GSEs' nonpartisan regulators and regulators of the current Democrat administration. In our second hearing we "balanced" the discussion entirely toward the point of view of the GSEs chief executives. Between hearings we heard from Chairman Greenspan, who not only advised that it was appropriate for Congress to review these matters, he also pointed our considerations in specific directions for concern. Our third hearing saw conservative and liberal activists raising concerns of systemic risk and mission compliance.

Today we are hearing from market participants - those who do business with the GSEs. Financial Services Roundtable - larger financial institutions, America's Community Bankers, and the Mortgage Bankers have direct interaction with the GSEs and hence should have valuable observations for the committee to consider. The Realtors and Homebuilders, who we might say do business with the businesses with direct contact with the GSEs, and who therefore should have the most independence and distance from the fray, will also share their insight.

To say that this issue has generated interest in the media is an understatement. I believe that we've had progress and that it's only moving forward. So in closing I want to extend my most hearty thanks to the witnesses today for offering their constructive comments.

INDEPENDENT COMMUNITY BANKERS of AMERICA

July 19, 2000

Honorable Richard H. Baker
Chairman, Subcommittee on Capital Markets, Securities
and Government Sponsored Enterprises
Banking and Financial Services Committee
U. S. House of Representatives
434 Cannon Building
Washington, D.C. 20515

Dear Chairman Baker:

Thank you for your letter of June 29, 2000, responding to my comments on the interim rule governing merchant banking activities under the Gramm-Leach-Bliley Act. Thank you, also, for requesting our "perspective on the systemic risk that the housing GSEs pose to our financial system and specifically to community banks." We very much appreciate the opportunity to comment on these issues. This opportunity is particularly timely in view of the hearings underway in your subcommittee on housing GSEs and H.R. 3703, the Housing Finance Regulatory Improvement Act. We regret that we haven't been accorded the opportunity to testify on this important bill.

First, a word of appreciation. The Federal Home Loan Bank reforms contained in the Gramm-Leach-Bliley Act, which you and Rep. Kanjorski championed, will make it easier for community financial institutions to join the system. They also liberalize the asset mix that can be pledged as collateral for advances, and expand the uses of advances for community financial institutions. These changes will help community financial institutions with their growing liquidity problems as loan-to-deposit ratios in many community banks hover at or above 90 percent.

As FDIC reports have indicated, banks are having problems growing their core deposits. We are pleased that a growing number of Representatives and Senators of both parties are deciding that existing levels of Federal deposit insurance should be increased to modernize the FDIC, to keep such core deposits in banks and credit unions, and to provide savings security for the millions of people who will be retiring in the years ahead with retirement savings in excess of $100,000.

LCBOs Pose Systemic Risk

Chairman Baker, I also want to thank you for the acknowledgement in your letter of June 29, that our concerns about systemic risk posed by large complex banking organizations (LCBOs) are well founded. This view, as you know, is shared by others, including Federal Reserve Board Governor Laurence H. Meyer who stated earlier this

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year that ". . . the growing scale and complexity of our largest banking organizations. . . raises as never before the potential for systemic risk from a significant disruption in, let alone failure of, one of these institutions." [1]

In that speech, Governor Meyer also disclosed that the Federal Reserve Board has appointed a team of supervisors to monitor the business strategy, management structure, key policies, and risk control systems of each LCBO. This step may be unprecedented not only in terms of the pre-emptive monitoring that it suggests to prevent a failure of one of these institutions, but also in terms of what this policy says about the level of systemic risk that each LCBO poses.

Limiting GSE Growth Would Increase LCBO Risk

In view of our shared concerns about the systemic risks posed by LCBOs, we find it puzzling that you are advancing a bill in Congress that may have the unintended consequence of actually increasing the systemic risk in LCBOs while it attempts to control the growth of GSEs. Homeownership in the U.S. now stands at record levels. Low interest rates and a strong economy have created an environment of strong consumer demand for housing loans. The housing GSEs have played a crucial ongoing role in helping lenders meet this demand. Thus, while the growth in the balance sheets of the GSEs are in part due to actions that they have taken to increase their business, much is a function of economic conditions and increased housing demand.

If legislation is passed to limit the size and activities of the GSEs, the housing finance demand that can no longer be met by these agencies will seek out competing providers, such as Wells Fargo, Chase Manhattan, GE Capital, PNC Financial Services, and Household International, all of whom are board members of FM Watch. It is a small wonder that FM Watch so strongly advocates tightening the regulation of Fannie Mae and Freddie Mac because it could produce a financial windfall for its members, while probably resulting in higher mortgage costs. But is a further concentration of assets in a handful of financial conglomerates, such as the membership of FM Watch, vs. diversification of assets among thousands of community banks through the housing GSEs, really in the national interest? We do not think so.

GLB Act Creating More LCBOs

Indeed, even without the market shift that would be produced by your bill, a dramatic consolidation of the banking industry and the financial services industry is already underway, and will be further encouraged by the provisions in the Gramm-Leach-Bliley Act of 1999, permitting the common ownership of banks, insurance companies and securities firms. This will result in the creation of even more LCBOs.

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[1] Speech before the National Bureau of Economic Research Conference, Islamorada, Florida, January 14, 2000.

FDIC economist Robert Oshinsky, in a study released last Fall entitled, *"Effects of Bank Consolidation on the Bank Insurance Fund,"* said that bank consolidations are concentrating banking assets in fewer and fewer institutions. The report showed that the largest 100 banks have gone from holding 51 percent of all bank assets in 1977 to holding 72.6 percent at the end of 1998. For the 25 largest banks, the increase is even more dramatic, with the percentage of industry assets held increasing from 30 percent in 1980 to 53.9 percent by the end of 1998.

If you agree, Chairman Baker, as you stated in your letter that ". . . the concerns. . . about systemic risk, large financial actors, and the stability of our nation's financial system are well founded," then I would think you would be concerned about advancing legislation that would produce even larger financial actors, that enjoy too-big-to-fail status, and more systemic risk.

Investment Levels

Chairman Baker, you stated the following in your letter: "I am sure that Undersecretary of the Treasury Gensler's comments stating that GSE debt has become a significant portion of the capital of the banking system is of interest to the ICBA and its membership." Financial institutions must hold investments for liquidity purposes, to meet loan demand and deposit withdrawals. Banks need high quality, highly liquid instruments, and debt of the Treasury and the GSEs fit these requirements.

If banks are limited in their ability to hold GSE debt, they will have to seek other investments to replace them that are higher risk, increasing the risk to the entire banking system. Concern about systemic exposure to GSE debt may be replaced with concern about exposure to corporate debt—one of few investment alternatives banks have available. Is it not better for the banking system to be more heavily invested in GSEs that are federally regulated than in unregulated corporations?

Due to the nation's economic strength, we are now able to pay down the national debt, which results in fewer and fewer Treasury securities outstanding. As this is occurring, the demand for residential mortgages remains relatively strong. The result is that GSE debt is increasing at the same time Treasury debt is declining. No one would suggest that we not pay down Treasury debt to keep it from being overshadowed by GSE debt. But should we put restraints on GSE debt simply to maintain historic relationships, knowing that the result could be higher homeownership costs? This would be particularly damaging at a time when the level of homeownership is on the rise, including homeownership to African Americans and other historically underserved minority groups. Thousands of potential homeowners could be beyond the financial reach of a home mortgage if mortgage debt is moved from the GSEs to the more expensive private sector, or if the liquidity is not there at all to provide loans in our communities. Most likely to be hurt are lower income people who will see the cost of a mortgage increase to a level that it is no longer affordable for them.

ICBA Comments on H.R. 3703

Now, I would like to turn my attention to several specific provisions in H.R. 3703 that are of concern to community bankers.

Consolidation of Regulators

Among other things, this legislation calls for the consolidation of the regulators of Fannie Mae, Freddie Mac and the Federal Home Loan Banks. Although each of these GSEs was initially established to support residential housing, the purpose of the Federal Home Loan Banks has expanded beyond the narrow housing mission of Fannie Mae and Freddie Mac. The differences were made even more pronounced with the passage of the Gramm-Leach-Bliley Act of 1999, as mentioned above, which gave the Federal Home Loan Banks broader authorities to support lending to small business and agri-businesses through community financial institution members. Accordingly, we believe the Federal Home Loan Banks need their own regulator that can focus on their special mission and lines of business. We urge you to continue to recognize the unique role of the Federal Home Loan Banks.

Repeal GSE Lines of Credit

Your bill also repeals the Treasury lines of credit to the GSEs. The ICBA strongly opposes this provision. Currently, Fannie Mae and Freddie Mac each have a $2.25 billion line of credit while the Federal Home Loan Bank System has a $4 billion line of credit. These lines of credit are important for the issuance of securities at favorable prices as they give the capital markets evidence of the government's willingness to stand behind these agencies. Should these lines be eliminated, the cost of mortgages and advances would likely increase, resulting in higher mortgage rates and other loan rates to consumers, businesses and farms across the country.

Clearly, the housing GSEs are working well to accomplish their mission, as evidenced by the record level of homeownership in the United States. Homeownership is becoming more and more available to segments of our population that previously experienced difficulty in obtaining mortgages. Our home ownership system is the envy of the world, and Fannie Mae and Freddie Mac are key pillars of support permitting community banks to provide financing behind this American dream. We cannot say this about the members of FM Watch. We must not allow legislation to reverse this trend, particularly since we see no problems regarding the regulation and agency status of the GSEs that need to be addressed.

It also may be worth noting that the last time the Congress addressed the too-big-to-fail issue, in 1991, the law Congress wrote just codified the steps that must be taken for the President to make such a finding. The law ratified the existence of too-big-to-fail, which represents an enormous subsidy beneficial to key members of FM Watch.

We all witnessed the financial markets' reactions to the suggestion of less government backing of the GSEs' securities—even if it is only a perceived guarantee—as evidenced by Undersecretary Gensler's remarks before your Subcommittee on March 22, 2000. While the changes in the GSEs' regulation and agency status currently under discussion may only come at some point in the future, the market disruption that the discussion causes hurts borrowers and investors today.

Prior Approvals Requirements

The bill imposes onerous new prior approval requirements on the GSEs that do not exist for private sector entities. We agree that because the GSEs have special privileges, they must not expand their charters. However, the GSEs should not be disadvantaged by a regulatory scheme that does not exist in the private sector, unless it is necessary for safety and soundness purposes. The financial markets are evolving rapidly, particularly as the use of technology is being integrated into the mortgage loan making process. The ICBA is concerned that if this onerous regulatory approval process is imposed on the GSEs, they will be disadvantaged in their ability to introduce new products and programs in a timely manner.

Congress mandated goals for Fannie Mae and Freddie Mac for the purchase of mortgages to targeted consumers and targeted areas. The Federal Home Loan Banks have similar responsibilities to reach out through their members to underserved populations. We believe that the GSEs must have the ability to respond rapidly to a changing market as long as safety and soundness is not compromised. It would be unfortunate if these underserved populations and areas that have been passed over by private sector lenders were further disadvantaged because the GSEs that were given responsibilities to serve them were hobbled by regulatory red tape.

Removal of Super Lien Authority

The ICBA strongly opposes the removal of the Federal Home Loan Banks' super lien as it will raise the cost of funds to Federal Home Loan Bank members and as a result, to consumers, and hamper the Federal Home Loan Banks' ability to provide liquidity to its members. If the Federal Home Loan Bank super lien is removed, Federal Home Loan Banks will need to focus resources on examining collateral on a loan by loan basis, resources better used to keep funds flowing from the Federal Home Loan Banks, through the members into the communities. The Gramm-Leach-Bliley Act collateral provisions took a major step forward in expanding the base of eligible collateral. Yet, this provision would take a significant step backwards because without the super lien, much larger haircuts will be imposed on collateral values, decreasing the amount of collateral available for advances.

If the super lien is removed, it will take members longer to obtain funds since more time will need to be spent checking the collateral. Thus, it will make the Federal Home Loan Banks significantly less useful as a liquidity source. Also, member customers will need to wait longer for their loans to be funded. We do not believe that

there are safety and soundness issues that would necessitate the removal of the super lien. Rather, its removal would make the Federal Home Loan Banks a less efficient liquidity and funds provider and increase the cost of funds to consumers.

Attachment

Finally, I have attached a letter we just wrote to Treasury Secretary Summers expressing our grave concerns about the Treasury proposals that would limit the ability of banks to hold GSE debt.

We hope these comments are helpful in your committee's deliberations on this legislative proposal.

Sincerely,

Thomas J. Sheehan
President

Enclosure

CC: Honorable Paul Kanjorski

ICBA
INDEPENDENT COMMUNITY
BANKERS of AMERICA

March 24, 2000

The Honorable Lawrence H. Summers
The Secretary of the Treasury
Department of Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Dear Mr. Secretary:

We are concerned about the comments made by Treasury Undersecretary Gary Gensler in his testimony this week before the House Banking Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises in support of legislative proposals that would restrict the market for securities issued by Fannie Mae and Freddie Mac.

The most damaging aspect of the proposed legislation is the immediately raised cost to housing. Mr. Gensler acknowledges that GSE borrowing costs are 30 to 40 basis points lower than AA and AAA rated financial institutions. Also, the GSEs have saved approximately $970 million by being exempt from SEC registration and state and local taxes. These costs, if incurred, would have to be recovered in higher consumer costs for housing.

Just the discussion of this unexpected proposal has raised the cost of housing, as evidenced by the immediate jump in GSE debt interest rates in response to Mr. Gensler's remarks. The world envies the U.S. housing market and the high level of homeownership. This would not be the case, but for the housing GSEs.

A more subtle cost would be borne by investors, such as ICBA's community banks, much of which would have to be passed on to our customers. By relegating the GSEs to private status, banks would have to

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reduce their GSE holdings. GSE debt is one of a very limited number of investments that are eligible as collateral for state and municipal deposits. Many community banks would have to replace GSE investments with Treasury securities at rates that currently range from 25 to 50 basis points below comparable GSE securities. The loss in income would be passed on to state and municipal depositors and/or the banks' private customers and owners. Also, we are concerned about the possible implication for banks' risk-based capital, should these securities lose their agency status.

Mr. Gensler correctly points out that the "government's fiscal discipline is leading to less Treasury debt --- these factors have caused the GSEs to occupy a more central role in capital markets than ever before." The 30-year Treasury has been the benchmark interest rate until very recently when the significant reduction in supply forced the market to find new benchmarks. GSEs are now beginning to fill the void. The proposed legislation would destabilize GSEs and would force the market to settle for less suitable benchmarks.

It also seems that these potentially disruptive proposals would serve no real purpose, since Congress is not likely to allow Fannie Mae or Freddie Mac to fail, any more than the regulators permitted large banks and LTCM to fail. The damage to the economy would be too great. And, failure would be temporary anyway. Mr. Gensler points out that Fannie Mae became insolvent on a mark-to-market basis in the early 1980s, when rates rose to unprecedented highs. It did not take long for rates to fall back to more normal levels and Fannie Mae was no longer insolvent.

It is interesting to note that Mr. Gensler recognizes the disruptive effect of the legislative proposals when he says, "Congress should seriously consider --- a sufficient transition period to prevent any market disruption." We are not sure that a transition period of 5 years, for example, would reduce the market disruption for 10, 20 and 30-year securities.

We are also concerned that the Undersecretary's testimony did not give adequate recognition to the fact that in passing the Gramm-Leach-Bliley Act the Congress reaffirmed and broadened the role of the Federal Home Loan Bank System in providing advances to community financial institutions.

We seek your assurances that the Undersecretary's proposal is in no way designed to erode this new bipartisan Congressional mandate to make the Federal Home Loan Banks more responsive to addressing the burgeoning funding and liquidity needs of the nation's community financial institutions.

Sincerely,

Thomas J. Sheehan
President

Cc: Chairman Greenspan
Chairman Leach
Chairman Baker
Rep. La Falce
Rep. Kanjorski
Sen. Hagel

OPENING STATEMENT OF
RANKING MEMBER PAUL E. KANJORSKI
SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES,
AND GOVERNMENT SPONSORED ENTERPRISES

HEARING ON H.R. 3703,
THE HOUSING FINANCE REGULATORY IMPROVEMENT ACT

THURSDAY, JULY 20, 2000

Mr. Chairman, thank you for the opportunity to speak before we begin our fifth day of proceedings on H.R. 3703, the Housing Finance Regulatory Improvement Act. In my opening comments today, I would like to examine where we have been since our last hearing, where we are now at this hearing, and where we are going in considering the many complex issues related to government-sponsored enterprises or GSEs.

At our last hearing, I questioned several of our witnesses about the need to provide the Office of Federal Housing Enterprise Oversight with the money it needs to regulate the safety and soundness of Fannie Mae and Freddie Mac. There is nothing more important than effective regulation so that we can prevent improper activities from occurring. Each of the taxpayer group witnesses supported providing OFHEO with the money that it needs as it works to implement its risk-based capital rule and improve its ongoing examinations of the GSEs.

Immediately after our last hearing, we voted on the House floor on an amendment offered by Congressman Hinchey to the VA/HUD appropriations bill to restore the $4.7 million in additional funds that OFHEO's director had requested. Unfortunately, the amendment failed by a vote of 207 to 211. All of the Democrats on our Subcommittee supported the amendment, which would have passed if just a few more of the Subcommittee's Members on the other side of the aisle had supported the measure. From this vote I must conclude that not only has the House not reached consensus on the need to strengthen the GSEs' regulation, but also our Subcommittee has not reached consensus on these matters, even though we have carefully studied them for many months.

At our previous hearings I have also noted that in order for our oversight of GSEs to be fair and effective, we must work to ensure that our proceedings are well crafted. Accordingly, I have requested that we convene a public roundtable discussion with representatives from all of the interested parties. A roundtable would promote a free, fair, and vigorous deliberation by forcing the participants to challenge each other's assumptions and assertions. If we pursue any further action on H.R. 3703 in the 106th Congress, I hope that we will finally organize a roundtable to understand more completely the need for and implications of this proposal.

Moreover, in conducting any hearing on these matters, I have said at past meetings that we must ensure that our panels are balanced, containing a multiplicity of interest viewpoints and a broad representation of individuals. I am therefore pleased that representatives from the National Association of Home Builders and the National Association of Realtors, which I requested, are joining us today. I commend the Chairman for inviting them.

In addition to the knowledgeable market participants with us today, I would have liked to have heard from others. For example, the Independent Community Bankers of America could have detailed for us an important perspective on the implications of H.R. 3703 on small banks,

small towns, and the Federal Home Loan Bank system. In a letter that I received from their president yesterday, he indicates that his group believes the legislation would "result in higher mortgage rates and other loan rates to consumers, businesses, and farms across the country."

I also received a letter on H.R. 3703 from the president of the National Association of Federal Credit Unions earlier this week. That letter encourages us to preserve the existing regulatory framework for GSEs. In order to improve the quality of today's proceedings, I would request unanimous consent to submit for the record these and other letters that I have recently received from national trade associations, state organizations, housing finance companies, and other market participants.

Finally, Mr. Chairman, because we are in the waning days of the 106th Congress with fewer than 30 legislative days remaining, I must ask where are we going in our deliberations over H.R. 3703. During my opening remarks at each of our previous hearings, I have stated that we must move forward cautiously and carefully in our consideration of this legislation. We must not pursue a course of haste where wise men fear to tread.

Just as we have not reached consensus in our Subcommittee on OFHEO's funding level, we have not reached consensus on any of the issues contained in H.R. 3703. I believe that we should not create uncertainty for the markets and regulators. I believe that we should not accidentally raise homeownership costs. I believe that we should not mark up this bill this year.

In closing Mr. Chairman, improving the efficiency and effectiveness of our nation's successful housing finance system while protecting taxpayers from unnecessary risks are matters that require extensive study before our Subcommittee contemplates any legislative action. A truncated process could lead to countless unintended consequences. I look forward to continuing to work with you in examining these issues and to hearing from our panelists today.

LETTERS EXPRESSING CONCERN ABOUT H.R. 3703 FROM MARKET PARTICIPANTS

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National Associations

Independent Community Bankers of America (ICBA)
National Association of Federal Credit Unions (NAFCU)
National Association of Real Estate Brokers, Inc. (NAREB)

State Associations

California Building Industry Association (CBIA)
Mortgage Bankers Association of Mississippi
New York Housing Conference

Companies and Other Parties

Cendant Mortgage – Mount Laurel, NJ
Center for Hope Hospice – Elizabeth, NJ
Columbia River Bank Mortgage Group – Bond, OR
Countrywide – Calabasas, CA
First Horizon Home Loans – Irving, TX
Fleet Mortgage Group – Columbia, SC
Irwin Mortgage – Indianapolis, IN
New America Financial – Dallas, TX
North American Mortgage Company – Tampa, FL
Plymouth Savings Bank – Middleborough, MA

ICBA
INDEPENDENT COMMUNITY
BANKERS of AMERICA

July 19, 2000

Honorable Richard H. Baker
Chairman, Subcommittee on Capital Markets, Securities
and Government Sponsored Enterprises
Banking and Financial Services Committee
U. S. House of Representatives
434 Cannon Building
Washington, D.C. 20515

Dear Chairman Baker:

Thank you for your letter of June 29, 2000, responding to my comments on the interim rule governing merchant banking activities under the Gramm-Leach-Bliley Act. Thank you, also, for requesting our "perspective on the systemic risk that the housing GSEs pose to our financial system and specifically to community banks." We very much appreciate the opportunity to comment on these issues. This opportunity is particularly timely in view of the hearings underway in your subcommittee on housing GSEs and H.R. 3703, the Housing Finance Regulatory Improvement Act. We regret that we haven't been accorded the opportunity to testify on this important bill.

First, a word of appreciation. The Federal Home Loan Bank reforms contained in the Gramm-Leach-Bliley Act, which you and Rep. Kanjorski championed, will make it easier for community financial institutions to join the system. They also liberalize the asset mix that can be pledged as collateral for advances, and expand the uses of advances for community financial institutions. These changes will help community financial institutions with their growing liquidity problems as loan-to-deposit ratios in many community banks hover at or above 90 percent.

As FDIC reports have indicated, banks are having problems growing their core deposits. We are pleased that a growing number of Representatives and Senators of both parties are deciding that existing levels of Federal deposit insurance should be increased to modernize the FDIC, to keep such core deposits in banks and credit unions, and to provide savings security for the millions of people who will be retiring in the years ahead with retirement savings in excess of $100,000.

LCBOs Pose Systemic Risk

Chairman Baker, I also want to thank you for the acknowledgement in your letter of June 29, that our concerns about systemic risk posed by large complex banking organizations (LCBOs) are well founded. This view, as you know, is shared by others, including Federal Reserve Board Governor Laurence H. Meyer who stated earlier this

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year that "... the growing scale and complexity of our largest banking organizations... raises as never before the potential for systemic risk from a significant disruption in, let alone failure of, one of these institutions."[1]

In that speech, Governor Meyer also disclosed that the Federal Reserve Board has appointed a team of supervisors to monitor the business strategy, management structure, key policies, and risk control systems of each LCBO. This step may be unprecedented not only in terms of the pre-emptive monitoring that it suggests to prevent a failure of one of these institutions, but also in terms of what this policy says about the level of systemic risk that each LCBO poses.

Limiting GSE Growth Would Increase LCBO Risk

In view of our shared concerns about the systemic risks posed by LCBOs, we find it puzzling that you are advancing a bill in Congress that may have the unintended consequence of actually increasing the systemic risk in LCBOs while it attempts to control the growth of GSEs. Homeownership in the U.S. now stands at record levels. Low interest rates and a strong economy have created an environment of strong consumer demand for housing loans. The housing GSEs have played a crucial ongoing role in helping lenders meet this demand. Thus, while the growth in the balance sheets of the GSEs are in part due to actions that they have taken to increase their business, much is a function of economic conditions and increased housing demand.

If legislation is passed to limit the size and activities of the GSEs, the housing finance demand that can no longer be met by these agencies will seek out competing providers, such as Wells Fargo, Chase Manhattan, GE Capital, PNC Financial Services, and Household International, all of whom are board members of FM Watch. It is a small wonder that FM Watch so strongly advocates tightening the regulation of Fannie Mae and Freddie Mac because it could produce a financial windfall for its members, while probably resulting in higher mortgage costs. But is a further concentration of assets in a handful of financial conglomerates, such as the membership of FM Watch, vs. diversification of assets among thousands of community banks through the housing GSEs, really in the national interest? We do not think so.

GLB Act Creating More LCBOs

Indeed, even without the market shift that would be produced by your bill, a dramatic consolidation of the banking industry and the financial services industry is already underway, and will be further encouraged by the provisions in the Gramm-Leach-Bliley Act of 1999, permitting the common ownership of banks, insurance companies and securities firms. This will result in the creation of even more LCBOs.

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[1] Speech before the National Bureau of Economic Research Conference, Islamorada, Florida, January 14, 2000.

FDIC economist Robert Oshinsky, in a study released last Fall entitled, *"Effects of Bank Consolidation on the Bank Insurance Fund,"* said that bank consolidations are concentrating banking assets in fewer and fewer institutions. The report showed that the largest 100 banks have gone from holding 51 percent of all bank assets in 1977 to holding 72.6 percent at the end of 1998. For the 25 largest banks, the increase is even more dramatic, with the percentage of industry assets held increasing from 30 percent in 1980 to 53.9 percent by the end of 1998.

If you agree, Chairman Baker, as you stated in your letter that ". . . the concerns. . . about systemic risk, large financial actors, and the stability of our nation's financial system are well founded," then I would think you would be concerned about advancing legislation that would produce even larger financial actors, that enjoy too-big-to-fail status, and more systemic risk.

Investment Levels

Chairman Baker, you stated the following in your letter: "I am sure that Undersecretary of the Treasury Gensler's comments stating that GSE debt has become a significant portion of the capital of the banking system is of interest to the ICBA and its membership." Financial institutions must hold investments for liquidity purposes, to meet loan demand and deposit withdrawals. Banks need high quality, highly liquid instruments, and debt of the Treasury and the GSEs fit these requirements.

If banks are limited in their ability to hold GSE debt, they will have to seek other investments to replace them that are higher risk, increasing the risk to the entire banking system. Concern about systemic exposure to GSE debt may be replaced with concern about exposure to corporate debt—one of few investment alternatives banks have available. Is it not better for the banking system to be more heavily invested in GSEs that are federally regulated than in unregulated corporations?

Due to the nation's economic strength, we are now able to pay down the national debt, which results in fewer and fewer Treasury securities outstanding. As this is occurring, the demand for residential mortgages remains relatively strong. The result is that GSE debt is increasing at the same time Treasury debt is declining. No one would suggest that we not pay down Treasury debt to keep it from being overshadowed by GSE debt. But should we put restraints on GSE debt simply to maintain historic relationships, knowing that the result could be higher homeownership costs? This would be particularly damaging at a time when the level of homeownership is on the rise, including homeownership to African Americans and other historically underserved minority groups. Thousands of potential homeowners could be beyond the financial reach of a home mortgage if mortgage debt is moved from the GSEs to the more expensive private sector, or if the liquidity is not there at all to provide loans in our communities. Most likely to be hurt are lower income people who will see the cost of a mortgage increase to a level that it is no longer affordable for them.

ICBA Comments on H.R. 3703

Now, I would like to turn my attention to several specific provisions in H.R. 3703 that are of concern to community bankers.

Consolidation of Regulators

Among other things, this legislation calls for the consolidation of the regulators of Fannie Mae, Freddie Mac and the Federal Home Loan Banks. Although each of these GSEs was initially established to support residential housing, the purpose of the Federal Home Loan Banks has expanded beyond the narrow housing mission of Fannie Mae and Freddie Mac. The differences were made even more pronounced with the passage of the Gramm-Leach-Bliley Act of 1999, as mentioned above, which gave the Federal Home Loan Banks broader authorities to support lending to small business and agri-businesses through community financial institution members. Accordingly, we believe the Federal Home Loan Banks need their own regulator that can focus on their special mission and lines of business. We urge you to continue to recognize the unique role of the Federal Home Loan Banks.

Repeal GSE Lines of Credit

Your bill also repeals the Treasury lines of credit to the GSEs. The ICBA strongly opposes this provision. Currently, Fannie Mae and Freddie Mac each have a $2.25 billion line of credit while the Federal Home Loan Bank System has a $4 billion line of credit. These lines of credit are important for the issuance of securities at favorable prices as they give the capital markets evidence of the government's willingness to stand behind these agencies. Should these lines be eliminated, the cost of mortgages and advances would likely increase, resulting in higher mortgage rates and other loan rates to consumers, businesses and farms across the country.

Clearly, the housing GSEs are working well to accomplish their mission, as evidenced by the record level of homeownership in the United States. Homeownership is becoming more and more available to segments of our population that previously experienced difficulty in obtaining mortgages. Our home ownership system is the envy of the world, and Fannie Mae and Freddie Mac are key pillars of support permitting community banks to provide financing behind this American dream. We cannot say this about the members of FM Watch. We must not allow legislation to reverse this trend, particularly since we see no problems regarding the regulation and agency status of the GSEs that need to be addressed.

It also may be worth noting that the last time the Congress addressed the too-big-to-fail issue, in 1991, the law Congress wrote just codified the steps that must be taken for the President to make such a finding. The law ratified the existence of too-big-to-fail, which represents an enormous subsidy beneficial to key members of FM Watch.

We all witnessed the financial markets' reactions to the suggestion of less government backing of the GSEs' securities—even if it is only a perceived guarantee—as evidenced by Undersecretary Gensler's remarks before your Subcommittee on March 22, 2000. While the changes in the GSEs' regulation and agency status currently under discussion may only come at some point in the future, the market disruption that the discussion causes hurts borrowers and investors today.

Prior Approvals Requirements

The bill imposes onerous new prior approval requirements on the GSEs that do not exist for private sector entities. We agree that because the GSEs have special privileges, they must not expand their charters. However, the GSEs should not be disadvantaged by a regulatory scheme that does not exist in the private sector, unless it is necessary for safety and soundness purposes. The financial markets are evolving rapidly, particularly as the use of technology is being integrated into the mortgage loan making process. The ICBA is concerned that if this onerous regulatory approval process is imposed on the GSEs, they will be disadvantaged in their ability to introduce new products and programs in a timely manner.

Congress mandated goals for Fannie Mae and Freddie Mac for the purchase of mortgages to targeted consumers and targeted areas. The Federal Home Loan Banks have similar responsibilities to reach out through their members to underserved populations. We believe that the GSEs must have the ability to respond rapidly to a changing market as long as safety and soundness is not compromised. It would be unfortunate if these underserved populations and areas that have been passed over by private sector lenders were further disadvantaged because the GSEs that were given responsibilities to serve them were hobbled by regulatory red tape.

Removal of Super Lien Authority

The ICBA strongly opposes the removal of the Federal Home Loan Banks' super lien as it will raise the cost of funds to Federal Home Loan Bank members and as a result, to consumers, and hamper the Federal Home Loan Banks' ability to provide liquidity to its members. If the Federal Home Loan Bank super lien is removed, Federal Home Loan Banks will need to focus resources on examining collateral on a loan by loan basis, resources better used to keep funds flowing from the Federal Home Loan Banks, through the members into the communities. The Gramm-Leach-Bliley Act collateral provisions took a major step forward in expanding the base of eligible collateral. Yet, this provision would take a significant step backwards because without the super lien, much larger haircuts will be imposed on collateral values, decreasing the amount of collateral available for advances.

If the super lien is removed, it will take members longer to obtain funds since more time will need to be spent checking the collateral. Thus, it will make the Federal Home Loan Banks significantly less useful as a liquidity source. Also, member customers will need to wait longer for their loans to be funded. We do not believe that

there are safety and soundness issues that would necessitate the removal of the super lien. Rather, its removal would make the Federal Home Loan Banks a less efficient liquidity and funds provider and increase the cost of funds to consumers.

Attachment

Finally, I have attached a letter we just wrote to Treasury Secretary Summers expressing our grave concerns about the Treasury proposals that would limit the ability of banks to hold GSE debt.

We hope these comments are helpful in your committee's deliberations on this legislative proposal.

Sincerely,

Thomas J. Sheehan
President

Enclosure

CC: Honorable Paul Kanjorski

ICBA
INDEPENDENT COMMUNITY
BANKERS *of* AMERICA

March 24, 2000

The Honorable Lawrence H. Summers
The Secretary of the Treasury
Department of Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Dear Mr. Secretary:

We are concerned about the comments made by Treasury Undersecretary Gary Gensler in his testimony this week before the House Banking Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises in support of legislative proposals that would restrict the market for securities issued by Fannie Mae and Freddie Mac.

The most damaging aspect of the proposed legislation is the immediately raised cost to housing. Mr. Gensler acknowledges that GSE borrowing costs are 30 to 40 basis points lower than AA and AAA rated financial institutions. Also, the GSEs have saved approximately $970 million by being exempt from SEC registration and state and local taxes. These costs, if incurred, would have to be recovered in higher consumer costs for housing.

Just the discussion of this unexpected proposal has raised the cost of housing, as evidenced by the immediate jump in GSE debt interest rates in response to Mr. Gensler's remarks. The world envies the U.S. housing market and the high level of homeownership. This would not be the case, but for the housing GSEs.

A more subtle cost would be borne by investors, such as ICBA's community banks, much of which would have to be passed on to our customers. By relegating the GSEs to private status, banks would have to

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reduce their GSE holdings. GSE debt is one of a very limited number of investments that are eligible as collateral for state and municipal deposits. Many community banks would have to replace GSE investments with Treasury securities at rates that currently range from 25 to 50 basis points below comparable GSE securities. The loss in income would be passed on to state and municipal depositors and/or the banks' private customers and owners. Also, we are concerned about the possible implication for banks' risk-based capital, should these securities lose their agency status.

Mr. Gensler correctly points out that the "government's fiscal discipline is leading to less Treasury debt --- these factors have caused the GSEs to occupy a more central role in capital markets than ever before." The 30-year Treasury has been the benchmark interest rate until very recently when the significant reduction in supply forced the market to find new benchmarks. GSEs are now beginning to fill the void. The proposed legislation would destabilize GSEs and would force the market to settle for less suitable benchmarks.

It also seems that these potentially disruptive proposals would serve no real purpose, since Congress is not likely to allow Fannie Mae or Freddie Mac to fail, any more than the regulators permitted large banks and LTCM to fail. The damage to the economy would be too great. And, failure would be temporary anyway. Mr. Gensler points out that Fannie Mae became insolvent on a mark-to-market basis in the early 1980s, when rates rose to unprecedented highs. It did not take long for rates to fall back to more normal levels and Fannie Mae was no longer insolvent.

It is interesting to note that Mr. Gensler recognizes the disruptive effect of the legislative proposals when he says, "Congress should seriously consider — a sufficient transition period to prevent any market disruption." We are not sure that a transition period of 5 years, for example, would reduce the market disruption for 10, 20 and 30-year securities.

We are also concerned that the Undersecretary's testimony did not give adequate recognition to the fact that in passing the Gramm-Leach-Bliley Act the Congress reaffirmed and broadened the role of the Federal Home Loan Bank System in providing advances to community financial institutions.

We seek your assurances that the Undersecretary's proposal is in no way designed to erode this new bipartisan Congressional mandate to make the Federal Home Loan Banks more responsive to addressing the burgeoning funding and liquidity needs of the nation's community financial institutions.

Sincerely,

Thomas J. Sheehan
President

Cc: Chairman Greenspan
Chairman Leach
Chairman Baker
Rep. La Falce
Rep. Kanjorski
Sen. Hagel

NATIONAL ASSOCIATION OF FEDERAL CREDIT UNIONS
P.O. BOX 3769 • WASHINGTON, DC • 20007-0269
(703) 522-4770 • (800) 336-4644 • FAX (703) 524-1082

July 20, 2000

The Honorable Richard Baker
Chairman
Subcommittee on Capital Markets, Securities
and Government Sponsored Enterprises
Committee on Banking and Financial Services
U. S. House of Representatives
Washington, D.C. 20510

Dear Chairman Baker:

The National Association of Federal Credit Unions (NAFCU) – the only national organization exclusively representing the interests of our nation's Federal credit unions – commends you for convening a third day of hearings on H.R. 3703, the *Housing Regulatory Improvement Act*. When you introduced this bill on February 29 of this year Representative Jim Leach, the distinguished Chairman of the full Committee, joined with you as an original co-sponsor of your bill which according to its title is intended "to consolidate and improve the regulation of the housing-related Government sponsored enterprises, and for other purposes."

Having had an opportunity to review the *Housing Regulatory Improvement Act*, I would like to share with you and your colleagues on the Capital Markets, Securities and Government Sponsored Enterprises Subcommittee the views of the National Association of Federal Credit Unions (NAFCU), and respectfully request that this letter be included in the Subcommittee's hearing record on this bill.

Credit unions throughout the country play a vital role in assisting individuals, particularly those of modest means, in achieving the American dream of homeownership. Since Congress conferred mortgage-lending authority on Federal credit unions on November 10, 1978 with passage of Public Law 95-630, credit unions in increasing numbers have worked to implement mortgage-lending programs to meet the needs of their membership. For many credit unions the ability to sell conforming loans in the secondary market is an important if not essential component of their mortgage lending business plan. In fact, NAFCU's analysis indicates that approximately one-third of all first mortgages extended by Federal credit unions are, in fact, sold in the secondary market (see chart labeled "FCU 1st Mortgages: Loans Sold/Loans Granted").

e-mail: nafcu@nafcunet.org • website: www.nafcunet.org

In calendar year 1999 Federal credit unions extended approximately $14.92B in first mortgage loans. Of that amount, $4.07B was sold in the secondary market (see chart labeled "Federal Credit Unions: 1st Mortgage Loans"). Nearly half (226) of the 489 Federal credit unions selling mortgages in the secondary market last year were NAFCU-member credit unions; these NAFCU-member credit unions accounted for 79.2% ($3.22 billion) of the total dollar volume ($4.07B) of Federal credit union originated loans sold in the secondary market. Against this backdrop it is clear that credit unions in general and NAFCU-member credit unions in particular have a vital interest in matters addressed in the *Housing Regulatory Improvement Act*.

A central component of the *Housing Regulatory Improvement Act* is the abolition of the Office of Federal Housing Oversight (OFHEO) and the Federal Housing Finance Board (FHFB), and the creation of the Housing Finance Oversight Board (the "Board") as a consolidated successor regulator. NAFCU is opposed to this idea and would like to focus its comments on that particular issue.

NAFCU believes that the proposal to replace the Office of Federal Housing Oversight and the Federal Housing Finance Board with a new Housing Finance Oversight Board (and the new responsibilities and regulations that would come with it) would create an additional layer in the oversight bureaucracy. Along with this additional bureaucracy there would appear to be added burdens placed on the GSEs -- and potentially lenders such as credit unions -- without any discernable benefit to safety and soundness.

NAFCU believes that legitimate parallels can be drawn between proposals to consolidate the regulation and oversight of Fannie Mae, Freddie Mac and the Federal Home Loan Banks on the one hand, and insured depository institutions on the other. At first blush proposals to establish a consolidated "super" regulator may have appeal, since they imply coordination of effort, economies of scale, and more efficient utilization of resources. In the financial services sector we have seen numerous proposals put forward over the years to establish just such a "super" regulator to oversee the activities of banks, thrifts and credit unions. However, for much the same reason NAFCU has opposed the inclusion of the National Credit Union Administration (NCUA) in such a consolidated "super" regulator, NAFCU would oppose a consolidation of OFHEO and the FHFB.

Specifically, NAFCU believes that – like Federal credit unions -- Fannie Mae, Freddie Mac and the Federal Home Loan Banks were chartered by Congress to advance specific public policy goals. The attainment of those goals is more likely to be achieved when the regulated entities operate under the purview of an agency not just familiar with but committed to their specific mission. Just as non-profit, member-owned and volunteer

driven credit unions are fundamentally different in organization, structure and mission from for profit banks and thrifts, likewise Fannie Mae and Freddie Mac are fundamentally different in organization, structure and mission from the Federal Home Loan Banks. Any economies or efficiencies to be derived through regulatory consolidation will necessarily come at a price; that price most likely being a dilution of commitment to their respective Congressional mandate.

Against this backdrop the NAFCU would encourage you, Mr. Chairman, and your colleagues on the Capital Markets, Securities and Government Sponsored Enterprises Subcommittee to preserve the existing regulatory and oversight framework relative to Fannie Mae, Freddie Mac and the Federal Home Loan Banks.

NAFCU believes that Freddie Mac and Fannie Mae both provide liquidity and stability in the marketplace; we would be concerned about any provisions that might adversely affect their ability to continue to do so. They also serve credit unions and credit union members by the manner in which they foster innovation and provide an investment source for new types of mortgages and affordable housing mortgage products. Any legislation should be sensitive to these important objectives and not unnecessarily impede the smooth operations of these entities or subject them to undue regulatory processes or restrictions.

Under H.R. 3703, new programs require a public review process entailing publication in the Federal Register with a 30-day comment period. Some might consider such a requirement onerous. In fact, it is not difficult to imagine that such a publication and notice requirement could trigger lobbying efforts by those who give corporate profit motives a higher priority than consumer friendly innovation in the marketplace, or by those that lack either the expertise or resources to roll-out certain new or innovative products.

NAFCU is also concerned that enactment of H.R. 3703 could have a potentially detrimental impact on the housing finance market by bureaucratizing the process by which lenders deal with the GSEs. This process has in the past, and remains today, a one-on-one process. Fannie Mae, Freddie Mac, and – to a lesser extent -- the Federal Home Loan Banks examine the individual strengths and weaknesses of lenders in the process of approving new programs or renewing the terms of annual master agreements (as is the case with Fannie Mae and Freddie Mac). NAFCU is concerned that GSEs would have far less flexibility to deal with the unique attributes of various lenders – particularly member-owned credit unions -- under the terms of the proposed legislation.

While NAFCU has no particular allegiance to the GSEs, in evaluating the proposed legislation in light of what Fannie Mae and Freddie Mac, in particular, have done for

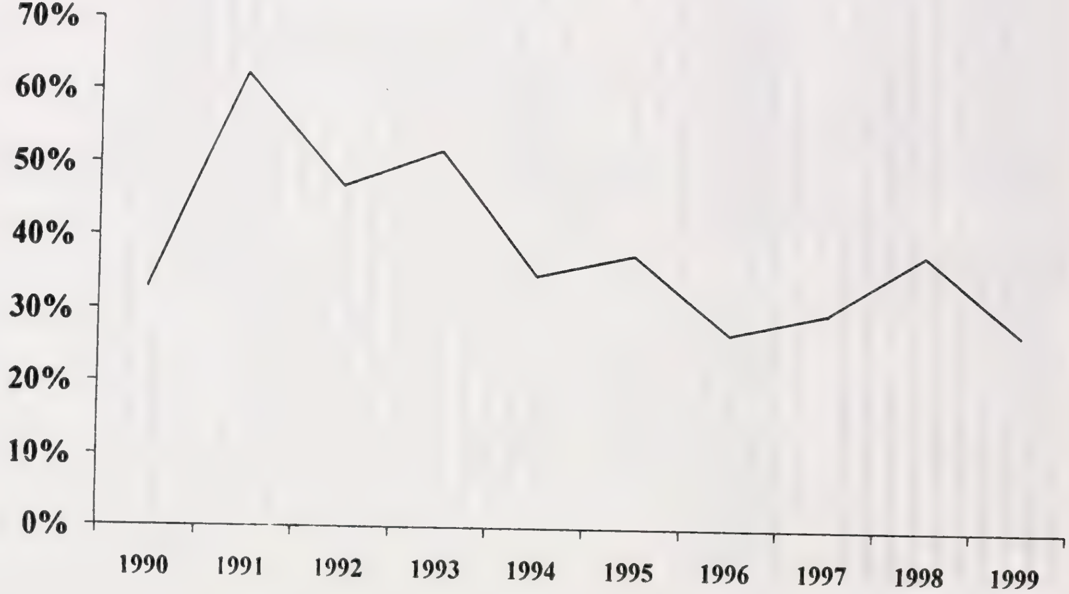
housing finance in this country, we have to step back and ask, *What is the problem?* Fannie Mae, Freddie Mac, and the Federal Home Loan Banks are doing their jobs well and are financially sound. They have not shown any proclivity for making careless decisions regarding the way they run their businesses, the new programs they choose to introduce, or the way in which they conduct their activities in the national securities market. If anything, Fannie Mae and Freddie Mac, in particular, have been innovators in managing their businesses to remain strong and continue to offer the all-important stability to the national secondary market. NAFCU would encourage the sponsors of H.R. 3703, the *Housing Regulatory Improvement Act* to think long and hard before tinkering with something that appears to be working so well.

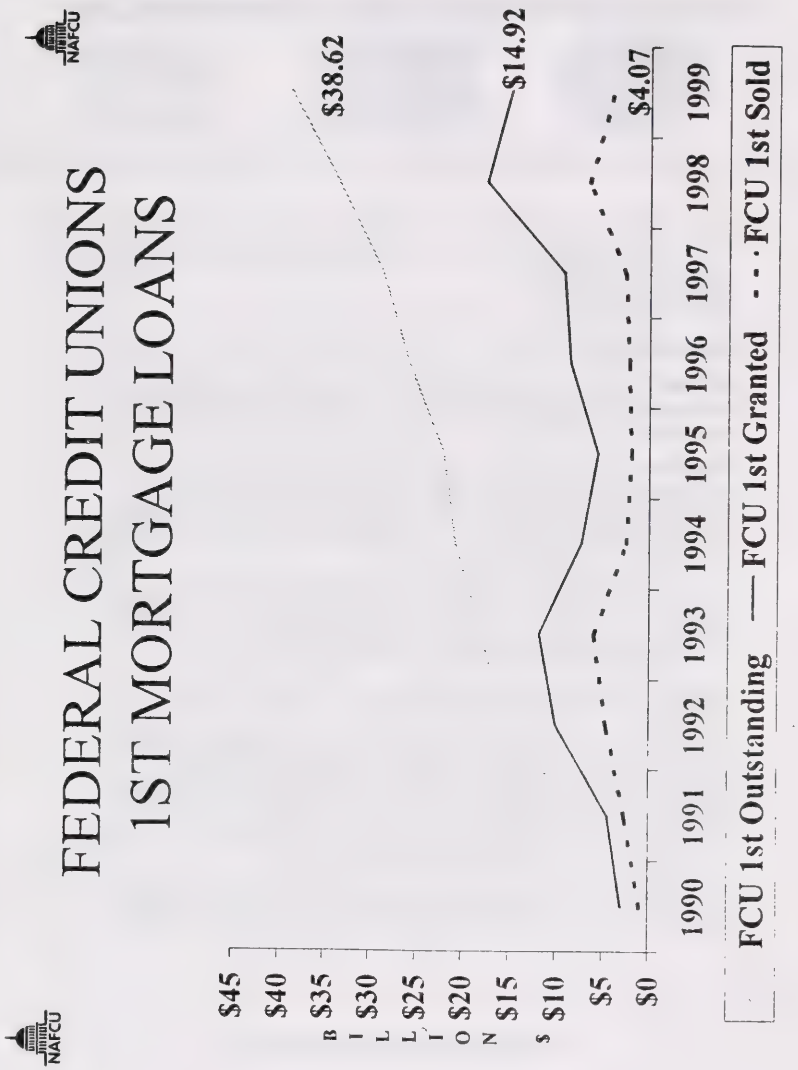
Thank you, Mr. Chairman, for your consideration of the views of the National Association of Federal Credit Unions. If you have any questions or if we may be of assistance to the Subcommittee concerning this or any other matter please do not hesitate to contact me or NAFCU's Senior Vice President and Deputy General Counsel, Bill Donovan, at (703) 522-4770.

Sincerely,

Fred R. Becker, Jr.
President & CEO

FCU 1ST MORTGAGES
LOANS SOLD/LOANS GRANTED





NAFCU
FEDERAL CREDIT UNIONS
1ST MORTGAGE LOANS
$45
$40
$35
$30
$25
$20
$15
$10
$5
$0
BILLION $
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
$38.62
$14.92
$4.07
FCU 1st Outstanding
FCU 1st Granted
FCU 1st Sold
NAFCU

NATIONAL ASSOCIATION OF REAL ESTATE BROKERS, INC.

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July 17, 2000

The Honorable Paul Kanjorski
U.S. House of Representatives
Washington D.C. 20515

Dear Representative Kanjorski,

The National Association of Real Estate Brokers Inc. (NAREB) is the oldest minority trade association in America. We were founded in 1947 on the principle that all citizens have the right to equal opportunities, regardless of race, creed, or color.

NAREB operates under a constitution and by-laws dedicated to preserving this right for all Americans. Our mission is to serve the underserved, and develop creative and effective methods of doing so. Over the years, our members have been at the forefront of the struggle to gain equal housing for all. We have become the voice and conscience of the proponents of equal housing.

Members of the NAREB organization are referred to as "Realtist". Although composed principally of African Americans and other minority real estate professionals, the Realtist organization is an integrated entity open to all qualified practitioners who are committed to achieving the ideals of the Realtist theme – Democracy in Housing.

NAREB would like to go on record in opposition to HR 3703, the Housing Finance Regulatory Improvement Act. NAREB strongly believes that Fannie Mae, Freddie Mac, and the Federal Home Loan Banks are key ingredients whose presence ensures liquidity and stability in the marketplace. The role these entities serve is important because their participation in the market enhances affordability and expands the types of mortgage products that are available in the market place. We fear that HR 3703 expands the ability of CRA lenders, mortgage insurers and mortgage bankers to extract undue profits from urban areas and minority home mortgage borrowers and restricts the growth of the homeownership rates of African and Hispanic Americans.

The real estate product innovation, particularly in recent years, has been key to reducing the cost of homeownership. Affordable housing loans, low downpayment products and mortgages designed to meet the needs of borrowers with credit blemishes are critical

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tools in making the dream of homeownership available to minorities and lower income families. The technology developments that these entities have invested in have increased the efficiency of the marketplace and reduced the processing time and cost of getting a mortgage.

In particular, NAREB, is opposed to those aspects of the proposed legislation that would have an impact on the ability of Fannie Mae, Freddie Mac and the Federal Home Loan Banks to ensure a stable, liquid source of mortgage finance. The provision to remove the Treasury line of credit for these entities would have a damaging impact on affordability. For borrowers at the margin, even a slight increase in mortgage interest rates impacts their ability to afford a home and make those payments. Homeownership is too important a goal for American families to tinker with the secondary market system that has brought so many benefits and has done so in a safe and sound manner.

NAREB is also opposed to the provisions in the legislation that would add unnecessary regulatory reviews and inhibit the development of mortgage products or novel approaches to doing business. Many of the products, reduced mortgage insurance, mortgages for credit impaired borrowers, low downpayment and technology initiatives in recent years could have been seriously affected or even prevented through the delays that such a review process would impose.

HUD and the Federal Housing Finance Board have sufficient regulatory powers to review the operations of the entities they regulate. There is no need to build a regulatory process that would impose undue delays and politicize the process of bringing innovations to the market.

The present regulatory scheme represents a unique balancing of mission and safety and soundness. The Department of Housing and Urban Development has responsibility to ensure that the mission of Fannie Mae, Freddie Mac is met and that their activities are within the limitations of their charters. The Office of Federal Housing Enterprise Oversight is empowered with ensuring that these entities are operated in a safe and sound manner. In the view of NAREB this is a unique approach that creates dynamic tension between what could be viewed as competing interests that results in proper balancing of these dual objectives. The Federal Housing Finance Board does not divide mission and safety/soundness responsibilities and perhaps some thought should be given to whether a

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single safety soundness regulator that coordinates the capital regimes of these organizations make sense. Given the different purposes and missions of the Federal Home Loan Banks versus Fannie Mae and Freddie Mac, NAREB supports the continuation of separate regulators to establish and review missions.

There may be ways to improve the regulatory regime and we understand from conversations with Fannie Mae and Freddie Mac that they are open to discussions on those matters, but the present structure of HR 3703 does not represent a workable base upon which to build.

Very Truly Yours,

Ernest Clark

Ernest Clark
President and CEO

CBIA.
California Building Industry Association
1215 K Street
Suite 1200
Sacramento, CA 95814
916/443-7933
fax 916/443-1960

Honorable Paul E. Kanjorski
2352 Rayburn House Office Building
Washington, DC 20510

July 18, 2000

Re: H.R. 3703 – Housing Finance Regulatory Improvement Act of 2000

Dear Congressman Kanjorski:

On behalf of the California Building Industry Association and our over 6,000 members engaged in residential construction, I regret to inform you we must oppose H.R. 3703. This bill is intended to streamline and restructure the regulatory framework for financial institutions involved in housing finance. However, H.R. 3703 would likely disrupt the housing finance market and only serve to stifle much needed innovation in the marketplace. Moreover, the bill is vague as to several key issues and would only seem to create confusion in the housing finance markets.

The bill proposes consolidating current regulatory bodies under a new agency – the Housing Finance Oversight Board -- to be formed by the measure. One of our primary concerns is that in the time it takes for this new agency to establish itself as fully operating, there will be substantial confusion among the regulated entities and regulators. This would have adverse effects on residential lending and may even compromise safety and soundness of regulated entities.

The bill's public disclosure requirements would also seem to be counterproductive, as well as detrimental to residential lending. Section 103 of the bill is overbroad and without standards, establishing the potential for regulators to demand public disclosure of proprietary information without reasonable restrictions.

Similarly, Section 110 of the bill would require GSEs to submit requests to conduct "new activities" to the administrative rule making process. Requiring businesses to publish new business initiatives in the Federal Register for notice and comment is a cumbersome proposition that not only presents unnecessary delays, but will also "chill" many worthwhile efforts at innovation that would otherwise serve consumers well.
Moreover, this section of the bill establishes the new Board's authority to disapprove new initiatives if the board concludes the activity would not be "in the public interest" – yet the legislation provides no standards for making such a determination.

The objective of streamlining regulation is actually undermined by Section 109's proposal to terminate HUD's general regulatory authority over Fannie Mae and Freddie Mac, but retain some of HUD's oversight power insofar as fair housing

issues. This portion of the bill would bifurcate authority in a manner that may simply lead to conflicting regulatory mandates and would certainly not be seen as a streamlining effort by any rational analysis. Further, it is our view that HUD's mandate to promote affordable and decent housing is critical component to the regulatory framework for GSEs.

In our final observation, we note the bill in several instances seems to establish dual, conflicting standards for the treatment of Federal Home Loan Banks as contrasted with the treatment of Freddie Mac and Fannie Mae. In particular, the provisions for risk-based capital tests and requiring the approval of new activities would seem to deliberately create an uneven playing field for GSEs.

An expanded secondary market for mortgage-backed securities is a financial services innovation which has made homeownership possible for thousands. Yet, long-standing financial industry practices and legal obstacles have in the past presented impediments to serving an even greater number of prospective homebuyers, particularly for aspiring homeowners among the newly-arrived and those trying to climb the economic ladder. Recent changes, however, in the mortgage banking industry, as well as with secondary mortgage market participants such as Fannie Mae and Freddie Mac, have created new approaches to underwriting loans for those who, under traditional methods, would not likely be able to obtain financing even though they represented "good risks" when one looked beyond standard underwriting criteria.

Unfortunately, H.R. 3703 would stifle such innovation in the future, and potentially jeopardize safety and soundness in residential lending. For the foregoing reasons, in addition to others, we must oppose this measure.

Sincerely,

Timothy L. Coyle
Senior Vice President/Governmental Affairs

MORTGAGE BANKERS ASSOCIATION OF MISSISSIPPI
P. O. BOX 22865 • JACKSON, MS 39225-2865
(601) 969-7817

The Honorable Richard Baker
434 Cannon House Office Building
U.S. House of Representatives
Washington, DC 20515

Via: Facsimile

Dear Representative Baker:

I am writing to express my opposition to HR 3703 as it is currently drafted. As Vice President of Mortgage Lending at Trustmark National Bank and President of the Mortgage Bankers Association of Mississippi, I work everyday to help families achieve their dream of homeownership. Several of the provisions of HR 3703 will harm our industry and more importantly harm the potential homeowners we work to serve.

There are several sections of this bill that raise concerns to me and others in our industry. HR 3703 will hurt consumers, limit lender's business opportunities and expand the government's control over the private housing industry.

An agile marketplace that encourages innovation and the development of new products best serves the American consumer. Fannie Mae and the secondary market are critical to our efforts to develop and bring to market new mortgage products. HR 3703 requires that any new mortgage product sold to Fannie Mae/Freddie Mac, or any new business process that either company develops, be submitted to the Federal Register for a 90-day comment period. The new regulator would then decide whether the public should have access to this new product based on a vague standard that the product or business process is in the "public interest".

This proposed legislation federalizes the operations of a well-managed company and ignores the realities of the marketplace. A lender with a new idea who would like to be the first in the market with it would have to wait for this entire regulatory process to unfold. Also, any proprietary information imbedded in the product design would be subject to full disclosure.

Section 103 allows the new Board regulator to require public disclosure of "financial, business, and other information" This provision gives the Board near unlimited powers to force disclosure of confidential, proprietary, and trade secret information.

Trustmark National Bank recently worked with Fannie Mae to develop several new and innovative products including a reduced documentation loan program for present Trustmark customers as well as a product to address borrowers who do not have the standard five percent down payment traditionally required by many mortgage transactions. These products serve consumers by making the mortgage process less time consuming and by reducing the overall costs required to purchase a home. If HR 3703 were enacted, our incentive to devote valuable time and resources into new

products would be hampered. The end result is that the consumer's mortgage choices would be unnecessarily limited.

I know the House Banking Subcommittee on Capital Markets and Government Sponsored Enterprises is meeting on July 20 to hear testimony from some of the industry groups affected by this proposed legislation. As an active Mortgage Banker, I hope you and your committee will consider my comments on the impact of this legislation.

Yours truly,

Joe W. McNeese III
President
Mortgage Bankers Association
Of Mississippi

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NY HC

10 July 2000

Congressmen Paul E. Kanjorski
Ranking Member
Subcommittee on Capital Markets, securities, and Government Sponsored Enterprises
U.S. House of Representatives
2353 Rayborn House Office Building
Washington DC, 20515-3811

Dear Ranking Member Kanjorski:

We are writing on behalf of the New York Housing Conference – New York's major affordable housing coalition – in order to express our concerns about the testimony presented before your committee from some who support technical changes to operating authorities used by the Home Loan banks. We believe that these changes, if enacted, would have very negative effects on the Home Loan Banks ability to serve homebuyers, community bankers and the nonprofit community, which they have been doing so effectively and impressively over the past few years.

As you know, the American system of financing housing is the model of the industrialized world. Our system has enabled tens of millions of Americans to become homeowners with low down payments and long-term mortgages. These advantages are in stark contrast to other countries in the industrialized world, and are due, in part, to the Home Loan Banks, Fannie Mae and Freddie Mac

The Home Loan Banks provide the kinds of credit resources that enable community bankers to design essential products, which in turn enhance the ability of local lenders to provide financial resources to families, individuals, businesses and community developments.

Any change in the GSE regulations, which would impact on the relationship between the GSE's and the federal governments, must be

preceded by extensive public hearings. These hearings must include all the groups that would be affected by these changes (including the nonprofit community, local lenders, and concerned individuals.)

Furthermore, the Federal Home Loan Bank System should be permitted a year to implement the Federal Home Loan Moderation Act of 1999 before new congressional directives are mandated. No new home loan bank legislation should be considered before 2001.

The GSE' s and community banks have played an essential role in building the successful public/private partnerships that have helped stimulate the economic prosperity of America. Any regulatory changes must be carefully discussed and reviewed in order not to upset the continued growth and efficiency of these partnerships.

We trust that you and other members of the committee and the Congress will consider all the foregoing factors as you debate the GSE issues and the housing industry.

We look forward to hearing from you.

Sincerely,

Clara fox　　　John Kelly　　　Carol Lamberg

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Chief Executive Officer

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CENDANT
Mortgage

July 13, 2000

The Honorable Richard Baker
U.S. House of Representatives
434 Cannon House Office Building
Washington, D.C. 20515

The Honorable Paul Kanjorski
U.S. House of Representatives
2353 Rayburn House Office Building
Washington, D.C. 20515

Dear Representatives Baker and Kanjorksi:

By way of introduction, Cendant Mortgage is a full service mortgage lender and a leader in relationship-driven mortgage banking, serving real estate brokers, affinity groups, credit unions, financial institutions, corporations and government agencies. In 1999, Cendant Mortgage provided over $25 billion in mortgage financing to American home buyers and is currently ranked as the Nation's sixth largest retail lender by *Inside Mortgage Finance* and the third largest online originator according to *National Mortgage News*. Our parent company, Cendant Corporation, is a global provider of real estate, travel, and direct marketing-related consumer and business services; its franchise operations include real estate and hotel brands such as Coldwell Banker, Century 21, ERA, Ramada, Days Inn and Howard Johnson.

We would like to provide our perspective and comments on the proposed legislation, HR 3703, the Housing Finance Regulatory Improvement Act. Cendant strongly believes that the secondary mortgage market through the operations of the government-sponsored enterprises, Fannie Mae and Freddie Mac, has brought liquidity and stability to the mortgage marketplace. Through the combined efforts of the GSEs and mortgage banking institutions such as Cendant and others the affordability of mortgage credit for American consumers has been significantly enhanced. Today America enjoys the highest level of homeownership at any point in our history.

We have strong concerns with any provisions of the legislation that would diminish the smooth operations of these entities and reduce their ability to function as they do today. Specifically, we oppose eliminating any statutory provisions that could disrupt their ability to meet their mission to serve consumers in times of economic crisis by moving into the market when other investors have withdrawn – such as occurred in October of 1998. Similarly Congress should not make any statutory changes that would directly impact the costs of mortgages to consumers.

There are two other provisions of this legislation that cause concerns. We strongly oppose the proposed approval process for new activities and the public disclosure requirements. These provisions will significantly interfere with Cendant's ability to work with our secondary market partners in developing innovative mortgage products for home borrowers.

With regard to the approval process for new activities, the definition of what activities would get swept into this provision is overly broad. This provision could hamstring a broad array of activities that lenders like Cendant typically engage in with secondary market partners. Our second concern with this provision is that it establishes a lengthy regulatory public comment process. Finally, the standard for judging any new activities—that an activity "is in the public interest"—is so broad that it is virtually meaningless.

The danger of a provision such as this is that a mortgage lender dealing with Fannie Mae or Freddie Mac would always face a risk that its proposal for doing business with these entities would be subject to expansive public disclosures on virtually any innovative concept. A competitor could pressure the regulator to demand public comment. Not only would this inject a lengthy delay into a company's plans to provide a new product, but also the end result would be tantamount to handing over a company's intellectual property to their competitors. Such a requirement will hamper the development and delivery of new and innovative products to American consumers. We oppose this unworkable provision.

HUD currently has authority to review activities that Fannie Mae and Freddie Mac are engaged in—yet HUD is required to protect the confidentiality of proprietary information. We believe this current approach strikes the correct balance between regulatory review and protecting a mortgage lender and the GSE from having their proprietary products, processes, and data open to unrestrained public scrutiny.

We applaud the Subcommittee's measured approach to this very important national issue by your decision to hold a series of hearings to obtain input from many sources rather than prematurely voting on the issue before all of the facts are carefully considered. Cendant strongly believes that any statutory or regulatory scheme that governs the operations of the GSEs should protect the American taxpayer from risk and should ensure that these entities operate within their charters. We would support reasonable changes that need to be effected to reach that objective.

Thank you for your consideration of our views.

Sincerely,

Terry Edwards

Terence W. Edwards

c: The Honorable James Maloney
The Honorable Marge Roukema

The Center For
H·O·P·E
Hospice

July 11, 2000

Congressman Paul E. Kanjorski
Ranking Member
Subcommittee on Capital Markets, Securities,
and Government Sponsored Enterprises
U.S. House of Representatives
2353 Rayburn House Office Building
Washington, D.C. 20515-3811

Dear Congressman Kanjorski:

The Federal Home Loan Banks and the other housing Government Sponsored Enterprises, FannieMae and FreddieMac, have recently been in the Washington spotlight. Hearings conducted in Washington have revealed that key federal officials have a lot to learn about these privately-owned companies and their public mission.

Consider one simple assumption, which makes the American system of housing finance the envy of the world: the low-down payment, long-term mortgage. Americans assume they can achieve homeownership with a down payment of less than 10 percent and manageable mortgage payments for as long as 30 years because the Home Loan Bank System developed this product and made it available through out member lenders.

Our product is not available in Germany, France, Great Britain, or Japan. That's one reason the typical down payment is 35 to 40 percent in Germany, while homebuyers in Japan have to put 50 to 60 percent down. And, unlike the United States, in these foreign countries a long-term mortgage is very rare. In Canada mortgages roll over during the first five years, while the fixed-rate term in Spain and France is about 15 years and in Germany it's five to ten years. And in those countries homeowners cannot refinance during these periods or rates go down unless they pay huge penalties.

One question that should be asked at the Washington hearings is: "Why are low down payment, fixed-rate mortgages with an option to refinance at little or no cost so common in the United States and so rare in the rest of the industrialized world?" If that question were asked, part of the answer would be: The Home Loan Banks, FannieMae and FreddieMac. I am aware of your support of these Government Sponsored Enterprises (GSEs); however, others in Washington do not seem to be aware of their significance.

One question that has been asked at these Washington hearings is why we need the Home Loan Banks, FannieMae, and FreddieMac. That's why it is important that key officials in Congress understand the Home Loan Banks and the value we provide.

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FATHER HUDSON HOUSE
Residential/Assisted Living Facility
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Remember **HOPE** *it is the heart of Hospice*

And unfortunately the House Banking Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises has heard testimony from some supporting technical changes to operating authorities used by the Home Loan Banks. The effect of these alterations would decrease, if not hobble, the Home Loan Bank's ability to serve. Consequently, the American homebuyer, the community banker, and non-profit housing industry would be hurt. And these injuries would occur without furthering public policy.

In summary, I believe that:

- *The Home Loan Banks provide the kinds of credit resources that enable community bankers to fashion vital products. This, in turn, enables local lenders to provide the financial lifeblood to individuals and families, businesses and communities.*

- *The Federal Home Loan Bank System should be permitted a year to implement the provisions of the major Federal Home Loan Bank Modernization Act of 1999 before new Congressional directives are mandated. No Home Loan Bank legislation should be considered until 2001.*

- *Any overhaul of the GSE regulators and changes to the public-private partnership between the GSEs and the Federal Government ought to be carefully considered and fully thought out. Hearings will be needed to be held so that adequate input can be received by all concerned parties to help identify and refine potential regulatory improvements.*

- *GSEs and the community banks are major contributors to the strength of the housing sector and in turn to our nation's prosperity. And changes to the terms of the extraordinarily successful public/private partnership should be done after careful assessment and with the goal of increasing efficiency, market competition and access to home finance by the American homebuyer.*

Sincerely,

Peter M. Shields

Peter M. Shields
Executive Director

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Honorable Paul E. Kanjorski
2352 Rayburn House Office Building
Washington, DC 20510

July 18, 2000

Dear Honorable Kanjorski;

Please find this letter as notice that I strongly disagree with bill HR 3703, (Housing Finance Regulatory Improvement Act of 2000) which would impact our ability to operate efficiently with the secondary market.

Public Disclosure of Information--Section 103
The new Board regulator could require public disclosure of "financial, business, and other information". This provision gives the Board virtually unlimited powers to force disclosure of confidential, proprietary, and trade secret data. I believe this could open up confidential customer information to scrutiny by competitors, interest groups, and others.

If Fannie Mae and Freddie Mac were forced to provide full information that could be made public on their mortgage scoring, technology developments, loan performance, etc. this would limit their incentive to invest resources in research and development, because their work product could potentially be required to be fully disclosed.

Approval of New Activities--Section 110
The Baker bill includes a proscriptive, lengthy regulatory process, expanding the regulatory review for new and ongoing activities, which include "any program, activity, or business process providing financing or other services.

This proposed change will dramatically alter the standard for how a program will be assessed. The proposed standard is vague and it would be virtually impossible for Fannie Mae to legally challenge a regulator's finding.

Current law provides sufficient authority for a regulator to review Fannie Mae's activities without excessively hampering the ability of the corporation to function in a business-like manner and conduct its ongoing operations without unwarranted regulatory encumbrance. Under HR 3703, the Government, not private businesses, would decide which products are brought to the market and in what manner.

This proposal is damaging because:

1) It covers too broad a spectrum of activities from new products to business processes.

2) It establishes a cumbersome public review process that would stymie innovation. New products would be subject to full public review before they are brought to market. Potentially, this could affect the GSE's ability to tailor custom deals to an individual lender's needs. Every lender would have access to the product prior to the 120 day approval process.

3) The approval process would become highly politicized--any competitor can delay or stymie any new activity--particularly because the standards outlined in the bill are so broad and vague.

In closing, because of our relationship with the Secondary Market Agencies we have automated underwriting technology which helps us reduce costs and improve the speed in which a loan is processed.

I appreciate your time. Again I must convey my concern about HR 3703 and urge careful consideration of this bill.

Sincerely,

Philip Hamilton, Sr. VP
Columbia River Bank Mortgage Group

ANGELO R. MOZILO, LL.D.
CHAIRMAN AND CHIEF EXECUTIVE OFFICER

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July 19, 2000

The Honorable Paul Kanjorski
U.S. House of Representatives
Washington, D.C. 20515

Dear Representative Kanjorski,

On behalf of Countrywide Home Loans, I am writing to share our thoughts concerning your proposed legislation H.R. 3703, the "Housing Finance Regulatory Improvement Act." We are pleased you have invited representatives from the homeownership and mortgage finance industries to the July 20th hearing to gain their input on the proposed bill. Clearly, passage of this bill would have a negative impact on how we all do business in this country.

The development of the secondary market has been critical to making the dream of owning a home possible for many Americans. The creation by Congress of the Government Sponsored Enterprises ("GSEs") gave true muscle to the secondary market allowing mortgage lenders access to funds even during times of volatile market changes. Fannie Mae has become an invaluable business partner for mortgage lenders with its ability to swiftly and deftly respond to changes in the financial market and make new and better products available to meet the changing housing needs of our country.

We are concerned that H.R. 3703 could severely limit that ability to respond to market needs. The proposed bill would require a regulatory review for all new "activity" which (i) is significantly different from prior approved programs or (ii) represents an expansion of programs above limits expressly contained in any prior approval. To obtain such approval would require submission for publication in the Federal Register for a comment period of not less than 30 days and subsequent approval by the newly created Board. We are very concerned that this will significantly curb new product introduction and will produce a negative drag on the market. It is exactly the facility of Fannie Mae to respond to changes in interest rates and other market and economic conditions by making new products available that provides stability in the mortgage market and allows more consumers to obtain mortgages even when rates are edging up. Especially in a rising rate market, we are at a loss as to why the government would move to severely limit that flexibility.

Other provisions of H.R. 3703 would require the GSEs to publicly disclose financial, business and other information on an annual basis. While we acknowledge the need for regulatory oversight, we strongly believe the Board must be required to give great deference to the need to protect proprietary information – especially information provided by mortgage lenders working with the GSEs to develop new business processes and products. Making such information public in advance of full development will place innovative lenders at a tremendous disadvantage and will serve as a serious disincentive for lenders to work with the GSEs on such endeavors.

Finally, we are also concerned that certain provisions of H.R. 3703 might have the unintended effect of increasing the cost of credit for many consumers by increasing the cost of funds for the GSEs. As drafted, the bill would repeal the current Treasury lines of credit that are currently available for the enterprises. It would also give the newly created Board the authority to limit the nonmission-related assets that an enterprise could hold at any time. We believe that both of these provisions would have a direct impact on the cost of funds for the GSEs – specifically it would increase their cost and thereby increase the cost for consumers. While we are, of course, cognizant of the importance of maintaining the safety and soundness of the GSEs, any curtailment of their financial flexibility must be carefully weighed against the potential adverse impact on their ability to fulfill their missions.

We appreciate the opportunity to share these concerns with you and the Subcommittee and we welcome the opportunity to work with you and your staff to make improvements in the mortgage market. If we can provide additional information, please do not hesitate to contact me or Sandy Samuels (818-225-3505).

Sincerely,

Angelo R. Mozilo

FIRST HORIZON.
HOME LOANS

Carroll M. Justice
Executive Vice President
Capital Markets

July 12, 2000

The Honorable Paul Kanjorski
Congressman
2353 Rayburn House Office Building
Washington, DC 20515

Dear Congressman Kanjarski:

Proposed House Bill HR 3703 would place significant and undesirable restrictions on the Government Sponsored Enterprises (GSE's.) The net effect of this legislation will be to reduce liquidity for mortgage lending and increase the cost of home ownership.

HR 3703 eliminates the "Call" that the GSE's have on the Treasury in time of financial crisis. The ability to raise funds and use them to support the housing finance market is critical to that market. Over the last several years, we have seen a reduction in the type and number of investors that purchase mortgage assets; thus reducing liquidity available to the housing market. The GSE's improve liquidity through the insurance of debt and through their ability to use Treasury funds to support an orderly housing finance market.

In the fall of 1998, liquidity in the financial markets dried up due to the collapse of the Russian financial system and Long Term Capital, a hedge fund. Without the liquidity injection of the GSE's we would have seen a significant disruption to the housing finance market. As it was, the sub prime market (not supported directly by the GSE's) did collapse. The "Call" on the Treasury, not only allows the GSE's to have a funding source back up for just this type of situation, but also assures investors in GSE's debt, that risk of default is low; thus improving the GSE's ability to raise funds when needed and at a reasonable interest rate.

A provision of HR 3703 would require a 90 day pre announcement of all new lending programs. contemplated by the GSE's. This provision will severely limit the GSE's ability to create new and innovative lending programs.

Many mortgage lenders, work closely with the GSE's to develop new lending programs. We pilot the program together and work out the kinks before they are released to the general market. The benefit to the "pilot" lender, for the work incurred, is to have a head start on the competition; Without this head start, no lender wants to spend the time and effort to develop a program that may not work and will be available to his competition immediately upon completion of the program. By pre-viewing the program, the benefit of piloting is taken away.

First Horizon Home Loan Corporation
4000 Horizon Way
Irving, TX 75063
Phone: 214-441-5400
Fax: 214-441-5499

We at First Horizon Home Loan Corporation strongly oppose the current provisions of HR 3703. It does not improve how we as mortgage lenders do business. It may serve to reduce liquidity in an industry that is already experiencing reduced investor demand. It will also increase housing cost to all Americans with the dream of home ownership.

Sincerely,

Carroll M. Justice
Executive Vice President

CM:sr

Fleet

A. William Schenck
Chairman and CEO

Fleet Mortgage Group

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Columbia, SC 29211-3201

July 18, 2000

The Honorable Richard Baker
434 Cannon House Office Building
U.S. House of Representatives
Washington, DC 20515

Dear Representative Baker:

I am writing to express my opposition to HR 3703 as it is currently drafted. As Chairman and CEO of Fleet Mortgage Group, I work every day to help families achieve their dream of homeownership. Several of the provisions of HR 3703 will harm our industry and more importantly harm the potential homeowners we work to serve.

There are several sections of this bill that raise concerns to myself and others in our industry. HR 3703 will hurt consumers, limit lender's business opportunities and expand the government's control over the private housing industry.

Consumers are best served by an agile marketplace that encourages innovation and the development of new products that meet consumer's needs. Fannie Mae and the secondary market are critical to our efforts to develop and bring to market new mortgage products. HR 3703 requires that any new mortgage product sold to Fannie Mae/Freddie Mac, or any new business process that either company develops, be submitted to the Federal Register for a 90-day comment period. The new regulator would then decide whether the public should have access to this new product based on a vague standard that the product or business process is in the "public interest".

This proposed legislation federalizes the operations of a well-managed company and ignores the realities of the marketplace. A lender with a new idea who would like to be the first in the market would have to wait for this entire regulatory process to unfold. Also, any proprietary information imbedded in the product design would be subject to full disclosure

Section 103 allows the new Board regulator to require public disclosure of "financial, business, and other information" This provision gives the Board nearly unlimited powers to force disclosure of confidential, proprietary, and trade secret information.

Fleet Mortgage recently worked with Fannie Mae to develop a product called the FleetOne Mortgage. This product serves consumers by streamlining the approval process and reducing costs. If HR 3703 were enacted, our incentive to devote valuable time and resources into new products would be hampered. The end result is that the consumer's mortgage choices would be unnecessarily limited.

I know the House Banking Subcommittee on Capital Markets and Government Sponsored Enterprises is meeting on July 20 to hear testimony from some of the industry groups affected by this proposed legislation. As an active Mortgage Banker, I hope you and your committee will consider my comments on the impact of this legislation.

Thank you.

Sincerely,

A. William Schenck
Chairman and CEO

Rick L. McGuire
President

Irwin Mortgage Corporation
P.O. Box 6089
Indianapolis, Indiana 46206-6089
9265 Counselor's Row
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317.844.7788
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July 17, 2000

Irwin Mortgage

The Honorable Paul E. Kanjorski
United States House of Representatives
2353 RHOB
Washington, DC 20515

Dear Representative Kanjorski:

As the president of a mid-size mortgage banking company, which deals primarily with first time and low to moderate income borrowers, I am writing you with concerns I have regarding the Housing Finance Regulatory Improvement Act of 2000. It is not clear to me what the motivation is for proposing this legislation, but it is very clear that it could have a significant negative effect on how Fannie Mae and Freddie Mac currently support lenders such as ourselves.

I do not argue that appropriate oversight and checks and balances are necessary in business. However, I feel the appropriate oversight for the GSEs exists today. I can only see your proposed legislation taking an efficient working system to a more bureaucratic slower way of doing business.

The mortgage market place is dynamic and fast changing. In order for our company to compete with the big banks and portfolio lenders, we need prompt attention and quick execution. The GSEs have been great partners and have allowed us to better serve our customers and remain competitive with larger institutions.

Our company strongly opposes this proposed legislation, and we urge you to reconsider your position.

Sincerely,

Rick L. McGuire
President

NEW AMERICA

AN AEGIS COMPANY

July 12, 2000

The Honorable Richard Baker
434 Cannon House Office Building
U.S. House of Representatives
Washington, DC 20515

Dear Representative Baker:

I am writing to express my opposition to the provisions in HR 3703. As the past president of the Texas Mortgage Bankers Association and due to my active involvement in the State Liaison Committee for the Mortgage Bankers Association of America, I've met and talked with many others who do not support this legislation.

Of utmost concern is Section 110, the provision that expands the regulatory review process for "new activities" for the Government Sponsored Enterprises (GSE). Under this procedure, where new activities must be published in the Federal Register for a comment period, the GSEs would lose their innovation. This would hinder the mortgage community's ability to work with the GSEs to bring new and creative products to our customers. I have personally demonstrated Fannie Mae's innovations such as desktop underwriting (DU) and Timely Payment Rewards to potential homebuyers. My visits were from the border between the United States and Mexico to some of the larger inter-city minority communities. During these calls I had the privilege of seeing the expression of hope in the eyes of people that never felt the opportunity for homeownership was meant for their family. Fannie Mae's DU and Timely Payment Rewards provided the vehicle of hope. Why change something that is working so well?

This provision covers too broad a spectrum of activities. It covers everything from new products to business processes. This would create too much government regulation, not allowing the GSEs to make any changes in the way they do business with their customers without first waiting no less than 30 days to hear the decision of the board. I was employed by Fannie Mae from 1967 to 1969 when the Association changed to its present structure. I know what it was like before. This provision would literally take Fannie Mae back to a past that would make it difficult if not impossible for a dynamic corporation to exist in the modern world of technology and change.

I have worked with Fannie Mae and Freddie Mac for a number of years and applaud them for their commitment to increasing homeownership rates. If HR 3703 moves forward in its current form, mortgage bankers across the country will be affected. This bill will have a huge impact on the way we do our business. I encourage you to consider my comments when the House Banking Subcommittee on Capital Markets and Government Sponsored Enterprises meets again on July 20. Thank you.

Sincerely,

Bud Terrell
CEO New America Financial

cc: Rep. Paul Kanjorski

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Richard A. Mirro
Chairman & Chief Executive Officer
813•636•5601

NORTH AMERICAN MORTGAGE COMPANY
A DIME COMPANY

July 18, 2000

The Honorable Richard Baker
434 Cannon House Office Building
U.S. House of Representatives
Washington, DC 20515

Dear Representative Baker:

I understand that you are continuing to hold hearings with regard to HR 3703. As CEO of North American Mortgage Company, one of the nation's largest residential lenders, I felt it important to convey my views with respect to certain aspects of the proposal.

First of all, let me make it clear that while North American Mortgage is a wholly owned subsidiary of a financial institution, DIME SAVINGS BANK, we do not share the same access to balance sheets and capital, as do our similarly sized competitors. Our primary strength and ability to meet the needs of our customers comes from the quality and talent of our staff, and to a large measure, the ability of Fannie Mae to provide us with product and pricing. Without the capabilities of the agencies, we and many other virtually independent mortgage bankers would be competitively disenfranchised by the major bank-owned mortgage companies (e.g. Chase, B of A, Fleet, Citicorp, etc.).

One more troubling aspect of HR 3703 deals with the proposed process for new product/process development by the agencies. The approach contemplated, which involves public comment periods with detailed disclosures, would be counter-productive to both enhancing home ownership and to mortgage industry competitiveness.

Enhancing the rate of home ownership requires a continuing process of product re-design and risk/return assessment. Doing this effectively involves not only the creativity of the agencies, but also that of the many lenders selling to them. Lenders are often the catalysts for stimulating new ideas and programs by the agencies, based on the feedback from their referral sources and the consumers that they serve. Most of us do not have the wherewithal to develop and support the programs on our own. Without the agencies, the products would not be offered or we would be dependent on the good graces of the large banks, which are at the same time, our fiercest competitors.

Any process which would expose new programs to lengthy, (90 days is an eternity in the mortgage business) vague reviews, implicitly grants an unfair competitive advantage to those players that have captive balance sheets and high levels of capital available to them.

If there were any evidence that the agencies have done a poor job of managing risk, I would be in full support of these efforts to constrain their activity. But given their track record and the essential role they fill in not only providing liquidity, but in insuring competitiveness, I hope you will reconsider at least this aspect of HR 3703.

Thank you.

Sincerely,

Richard A. Mirro
CEO/Chairman
North American Mortgage Company

Cc: Rep. Paul Kanjorski

PLYMOUTH SAVINGS BANK

ADMINISTRATIVE OFFICES: 95 BEDFORD STREET, P.O. BOX 1439, MIDDLEBOROUGH, MA 02346 508-946-3000

July 17, 2000

JUL 17 2000

The Honorable Paul Kanjorski
U.S. House of Representatives
Washington, D.C. 02515

Dear Representative Kanjorski:

I am writing to express concern with regard to House Bill H.R. 3703. The GSE's have been very effective in providing low cost mortgage financing and home ownership. They have also provided for a very efficient secondary market which has maintained a constant source of mortgage funds to all areas of the country regardless of local economic conditions. Their innovative mortgage programs and technology have significantly increased the spectrum of Americans who qualify for mortgages while reducing the cost of obtaining the mortgage.

Section 110 of the bill, which requires approval of the Board for all new programs and innovations, and also requires publication in the Federal Register for public commentary, is most disconcerting. The GSE's play a critical role in keeping competition prevalent in the mortgage market. There are companies who dominate the market and industry trade groups who are threatened by the uniqueness of the agencies' innovative products and expanded use of technology. These innovations have been critical in bringing competition and reduced mortgage cost to the market by providing technology and mortgage programs to small and medium size companies which otherwise could not afford to offer or obtain these objectives.

Fannie Mae has partnered with Plymouth Savings Bank and other mortgage providers to introduce new creative mortgage programs, some specifically designed to meet the needs of the community which we serve. Section 110 would allow our competitors to delay or possibly prevent our offering these mortgage programs, stifling competition in the mortgage market.

I am also concerned about the potential negative impact of the Bill regarding the cost and liquidity of mortgage funds. I will point out the agencies did not abandon New England during the difficult economic times incurred during the late 1980's and early 1990's. Many private providers of mortgage financing and insurance either curtailed their New England operations or significantly increased the cost due to the increased economic risk

The current number of Americans qualifying for home mortgage financing is the greatest in our history The cost of obtaining financing has been significantly reduced due to technological innovations and competition currently occurring in the market place. I would suggest the GSE's should be credited with much of this success.

Respectively,

W. D. Brennan

W. David Brennan
Senior Vice President

WDB/lgd

THE FINANCIAL SERVICES ROUNDTABLE

Testimony of

Steve Bartlett

President of

The Financial Services Roundtable

Before the

United States House of Representatives

Banking and Financial Services Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises

on

Improving Regulation of Government Sponsored Enterprises

July 20, 2000

My name is Steve Bartlett and I am the President of The Financial Services Roundtable. Thank you for inviting me to testify today on H.R. 3703, the Housing Finance Regulatory Improvement Act of 2000. The Roundtable supports this bill. While there are some areas of the bill which may need improvement, H.R 3703 establishes a framework that will allow regulators proper authority to control mission expansion by the government sponsored enterprises.

The Financial Services Roundtable is a national association whose membership is reserved for 100 companies selected from the nation's 150 largest integrated financial services firms. The member companies of the Roundtable engage in a wide range of financial activities, including banking, securities, insurance, and other financial service activities.

The Roundtable is a CEO-driven association that advocates the interests of integrated financial institutions primarily in the Congress, the federal agencies, and federal courts.

Let me begin today by commending the Chairman for introducing this legislation and for holding a series of hearings on this important topic. The Roundtable appreciates the time and resources that Chairman Baker, Ranking Member Kanjorski and all of the members of this Subcommittee have devoted to this issue. The role, mission, and activities of government sponsored enterprises deserves periodic review, and the Subcommittee's work in this area has promoted open and honest discussion of many of the key issues related to GSE's.

Before I present our views on the legislation, let me provide some background on the Roundtable's general views on this issue. As in many areas, the policy issues related

to GSE's are complex. Reasonable people can come to very different conclusions about the best course of action in this area. Indeed, the Roundtable's membership holds diverse views on this subject. Nonetheless, the views that I present today represent the predominant views of the majority of our member companies.

Let me also state that the Roundtable is not opposed to all of the activities of GSE's. Fannie and Freddie have played a key role for several decades in providing liquidity to mortgage markets. The Roundtable commends them for their success in fulfilling this core mission. Also, the Federal Home Loan Banks should be commended as well. One recent Federal Home Loan Bank innovation that deserves praise is the Mortgage Partnership programs. These programs are designed to increase capital available for mortgage lending and provide commercial banks and thrifts competitive alternatives in the secondary mortgage market. As with any dynamic business environment the increased competition translates into better rates and ultimately lower prices for consumers.

Structure of Supervisory Agencies and Regulatory Authority

H.R. 3703 would establish a new regulatory regime for supervision and regulation of GSE's by combining safety and soundness, and mission regulatory authority under one agency, the Housing Finance Oversight Board. The Roundtable supports this approach. Under the existing regulatory structure, safety and soundness and mission regulation for Fannie Mae and Freddie Mac are split among the Office of Housing and Urban Development and the Office of Federal Housing Enterprise Oversight (OFHEO). Conversely, the Federal Housing Finance Board regulates both mission and safety and soundness of the Federal Home Loan Banks. The Roundtable

believes that dividing mission and safety and soundness regulation between two regulators weakens the ability of regulatory agencies to fulfill their responsibilities. For example, investing in certain nonmission assets may have both safety and soundness and mission-related implications. By having authority to address both topics, the regulator will be better able to look at a GSE's activities in total and make appropriate judgements.

The bill would also change the manner in which the regulators are funded. Currently, OFHEO is subject to a highly politicized appropriations process, unlike virtually any other federal financial regulator. Mr. Chairman, we applaud you for recognizing that financial independence is critical to the stability of any regulatory agency. Although at times Roundtable members have disagreements with their regulators, we believe that strong and independent regulation is one of the critical components of their acceptance by consumers and investors both domestically and internationally.

By ensuring that adequate and timely funding is available by allowing the newly established oversight board to directly assess the institutions it regulates, your bill ensures that the new agency and the job it does will be free from the problems presented by unpredictable funding or political interference.

I want to note again that OFHEO is the only federal financial safety and soundness regulator that is currently subject to the appropriations process. The federal regulators that oversee our companies, including the SEC, OCC, Federal Reserve, OTS, FDIC and FTC are not subject to the appropriations process as is OFHEO. The Roundtable would support immediate action to remove OFHEO from the

appropriations process now. The strength provided by such action will ensure adequate resources while this bill is debated further.

Approval of New Activities

The bill would put in place a process for Board approval of new activities that the GSE's wish to undertake. The approach proposed in this bill, namely to require publication of new activities in the Federal Register and allow for public comment, maybe overly restrictive. However, the Roundtable agrees with the intent behind this provision. The current system for containing mission creep does not work. Take for example two activities that Fannie and Freddie have undertaken that the Roundtable believes goes beyond their intended mission. Fannie Mae has developed a program where it will purchase home equity loans originated at Home Depot stores. Ostensibly, these funds are then used for home improvement purposes. However, the Roundtable questions whether home equity loans in general, and loans originated through this program in particular, are within the scope of Fannie Mae's mission. Over 70 percent of home equity loans are used for general consumer credit purposes, including credit card consolidation, purchasing new automobiles or boats, financing education, or purchasing other goods. Such loans do not further Fannie's mission, not even when the loan proceeds are used solely to purchase goods from Home Depot.

Another example is the Freddie Mac Home Steps Home Buying Center. Through this program, Freddie Mac sells REO property directly to consumers. In fact, Freddie Mac has opened a storefront in a California strip mall, where consumers can view pictures of property, pre-qualify for a loan, visit the homes with a Home Steps buying counselor, purchase the home, apply for a loan, have the home inspected, and close on the home. An earlier version of the marketing material for this program promotes this

"new way to buy a home." According to this brochure, "most home purchases require visiting several locations in different parts of town: a real estate office, a lending institution, and an escrow company. At HomeSteps, each of these steps can be taken care of under one roof—the HomeSteps Home Buying Center." The implication of this statement is clear: it is no longer necessary to go to a bank, a thrift or another lender to get a mortgage loan because Freddie Mac can provide at their store. Perhaps most troubling, Freddie emphasizes its close relationship to the federal government by stating clearly on the front of the brochure that Freddie Mac is a "Congressionally Chartered United States Corporation." While Freddie's and Fannie's charters expressly prohibit them from engaging in primary market activities, Freddie obviously does not believe that using a retail storefront to sell homes and issue loans is a primary market activity.

In 1984, while a member of the House Banking Committee, I was a primary author of the Secondary Mortgage Enhancement Act to remove regulatory impediments to secondary mortgage transactions for the GSE's and private companies. While I am proud of my work on that legislation, I do wish that the Committee had the knowledge that we have today regarding the willingness of Fannie and Freddie to push their mission beyond the primary goal of promoting liquidity for secondary market mortgage transactions. If we had addressed this issue back then, I might not be sitting here today expressing our concerns about mission creep.

Nonmission Related Assets

H.R. 3703 would place limits on the non-mission related assets of the GSE's. The Roundtable supports this provision. As discussed previously, the GSE's often undertake actions that go far beyond what the original intent of their mission appears to have been.

Providing the regulator with sufficient authority to address nonmission related assets will help to address this issue.

Yearly Review of Enterprises by Rating Organizations

The Roundtable supports the provisions in H.R. 3703 that would require the GSE's to be rated by two nationally recognized rating agencies on an annual basis. Evidence supports the assertion that GSE's have an implicit government guarantee beyond the explicit benefits afforded to the enterprises from the federal government. Requiring this analysis will help to quantify this benefit for policymakers and the public and promote greater transparency in debt markets.

Risk-Based Capital

The Roundtable agrees with the changes to the statutory requirements for risk-based capital that this bill proposes. The exiting statutory standards for OFHEO's risk-based capital requirements are overly complicated and have contributed to the eight-year delay in promulgating final regulations. Capital regulations are one of the major tools that financial regulators use in regulating safety and soundness. This proposal provides the regulators with greater flexibility to establish appropriate capital regulations.

Conclusion

Chairman Baker, Ranking Member Kanjorski, and all members of the Subcommittee thank you for allowing me the opportunity to appear here today. The

Roundtable complements the work you have done by considering this legislation. The financial services industry recently has undergone a broad review of the overall regulatory structure in which we operate. The House Banking Committee, as well as several other Congressional Committees, are in the process of reviewing the regulatory framework governing swaps and other derivatives. Likewise, it seems appropriate that Congress consider the regulatory framework governing GSE's and this well-thought out legislation to address GSE-related issues.

I will be glad to answer any questions that the Committee might have.

**STATEMENT OF THE NATIONAL ASSOCIATION OF REALTORS®
BEFORE THE
UNITED STATES HOUSE OF REPRESENTATIVES
SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES, AND GOVERNMENT-SPONSORED ENTERPRISES
COMMITTEE ON BANKING AND FINANCIAL SERVICES
BY
DENNIS R. CRONK
PRESIDENT, NATIONAL ASSOCIATION OF REALTORS®
JULY 20, 2000**

INTRODUCTION

Chairman Baker and members of the Subcommittee, I am Dennis R. Cronk, president of the NATIONAL ASSOCIATION OF REALTORS®. I am a REALTOR® and broker/owner with the firm of Waldvogel, Poe and Cronk Real Estate Group, Inc., a full service residential and commercial real estate brokerage and management firm headquartered in Roanoke, Virginia. On behalf of the NATIONAL ASSOCIATION OF REALTORS® I am pleased to offer our views on H.R. 3703, the "Housing Finance Regulatory Improvement Act." REALTORS® believe that it is prudent that Congress consider the workings of the residential secondary mortgage market from time to time and evaluate the effectiveness of Fannie Mae and Freddie Mac in their capacity as facilitators of the secondary mortgage market and investors in home mortgage loans. Recent revisions in the mission of the Federal Home Loan Banks whereby member banks, moving beyond their traditional role of providing advances to member institutions for housing finance, are participating in a fledgling secondary market alternative to that provided by Fannie Mae and Freddie Mac also merits attention.

Mr. Chairman, the NATIONAL ASSOCIATION OF REALTORS® appreciates your invitation to present our viewpoint on H.R. 3703. Mr. Chairman, members of the Committee, while the NATIONAL ASSOCIATION OF REALTORS® speaks for 760,000 real estate professionals engaged in the industry, REALTORS® are also advocates for homeowners and those who aspire to own homes. It is our view that any oversight or review of the housing GSEs should also consider the public policy issues that affect homeownership opportunities for Americans. I hope that our testimony can be helpful in focusing the debate on how to strengthen oversight of the housing enterprises.

H.R. 3703 has been a lighting rod for criticism of the GSE these days. A recent witness before this Subcommittee characterized the growth and financial activities of Fannie Mae and Freddie Mac to a financial crisis similar to the savings and loans crisis of the 1980s just waiting

to occur.[1] A number of lenders maintain that Fannie Mae and Freddie Mac exceed their charters when purchasing subprime loans. These lenders make this argument despite the fact that the enterprises recently agreed to the affordable housing goals proposed by the Department of Housing and Urban Development, the GSEs' mission and program regulator, that specifically direct the GSEs to purchases more so-called A-minus loans that may facilitate homeownership among for more low- and moderate-income households. Some consumer and housing advocates maintain that Fannie Mae and Freddie Mac should purchase more mortgages that meet the Department of Housing and Urban Development affordable housing goals, but these same critics assert that the enterprises facilitate predatory lending by purchasing these subprime loans, which assumes that subprime lending is prima facie predatory.

According to the *Wall Street Journal*, executives of some of the largest financial institutions in the country are making the political rounds in Washington advocating "containment" of Fannie Mae and Freddie Mac.[2] These financial institution executives support legislation that would restrict the GSEs' investments and lending programs and remove the federal ties that lower the GSEs' borrowing costs and the implied federal backing for debt and mortgage backed securities issues. The GSEs' critics are certainly entitled to their views. REALTORS®, however, do not share them.

GSEs AND THE HOUSING FINANCE SYSTEM

For more than fifty years, the federal government has had a fundamental role in the nation's housing finance and homeownership policy. For nearly thirty years, Fannie Mae, Freddie Mac, and the Federal Home Loan Banks have used their federal charter benefits that Congress granted to help build a housing finance system that is the envy of most other countries that want increase homeownership. The United States is the best housed nation in the world due in no small part to the mortgage investment activities of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks.

The long economic expansion, together with innovative mortgage products in the primary and secondary mortgage markets, contributed to unprecedented five-year gain in homeownership rates between 1995 and 1999. National homeownership is at nearly 67 percent. According to NATIONAL ASSOCIATION OF REALTORS® research, forty-two percent of these homeowners are first-time purchasers. Homeownership among minorities and America's immigrant population account for almost 40 percent of the recent growth in homeownership.[3]

Innovation of the mortgage-backed security

Congress deliberately established the Fannie Mae and Freddie Mac and charged these enterprises, as a matter of public policy, with the mission to facilitate a secondary market in

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[1] *See* Statement of Peter J. Sepp on behalf of the National Taxpayers Union before the Subcommittee on Capital Markets, Securities, and Government-Sponsored Enterprises Banking and Financial Services Committee, U.S. House of Representatives, June 15, 2000.

[2] "Top Financial Executives to Seek Tighter Reins on Mortgage Lenders," ***Wall Street Journal***. July 12, 2000, p. A2

[3] Joint Center for Housing Studies of Harvard University, ***The State of the Nation's Housing***. Cambridge, Harvard University, 2000, p. 17.

conforming mortgages by purchasing investment quality loans. These two enterprises created the pass-through mortgage-backed security and its variants to attract investors in the full knowledge of the risks associated with tying up capital in long-term fixed rate instruments. This financial innovation created and maintained liquidity in the otherwise illiquid mortgage investment market. When Congress chartered Fannie Mae and Freddie Mac, the intention was to eliminate interest rate differences between regions of the country and to promote a national mortgage market. The mortgage-backed security and debt offerings of the GSEs effectively linked Wall Street to Main Street. Over time geographic shortages of mortgage funds and the cyclical availability of mortgage credit were minimized. There can be no denial that the GSEs benefit from their federal charter and associated benefits, but so do American homeowner and those lenders and others in the housing finance and real estate industries that support homeownership. Analysts estimate that mortgage interest rates are lower by between one and one half percent because of the secondary mortgage market. Homeowners benefit directly, which is a reflected in historically high homeownership level.

Increases in the mortgage interest rate can dramatically affect housing affordability by increasing the monthly cash costs of owning. Prospective buyers either fail to qualify at the higher rate or are unwilling to increase the share of their income going to shelter. Estimates of the number of buyers lost as rates increase depend on a complex array of factors – level of interest rates, income and house price distributions, mortgage underwriting standards, and demographic changes. It is important to note that the number of households that would fail to qualify as rates increase is a much larger number than the number who fail to purchase. This is because only between five and six percent of households buy a home in a given year.

Using data from the 1995 American Housing Survey[4], it is estimated that if mortgage interest rates rose by one percent, the number of households who would fail to qualify to buy a home is approximately 4,000,000 of which approximately 178,000 households per year would be unable to purchase a home.

Today's homeownership costs are lower and access to mortgage credit -- even for borrowers with blemished credit -- is easier and more equitable. Two primary obstacles remain as barriers to homeownership in this country, however -- the mortgage loan downpayment and costs associated with closing and settling the mortgage. Much of what Fannie Mae and Freddie Mac are doing in the current mortgage finance environment relates to lowering the costs of homeownership. REALTORS® applaud and support these activities.

Financial Marketplace, Competition and Innovation

Fundamental forces are transforming the U.S. housing finance system, with implications for the primary and secondary mortgage markets, the capital markets, the financial system, homebuyers, Congress, and the GSEs' regulators. All of these changes are occurring during the longest sustained economic expansion in U.S. history.

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[4] U.S. Department of Housing and Urban Development and U.S. Bureau of the Census, ***American Housing Survey***, 1995.

This current economic expansion heightens competition and consolidation among mortgage lenders and banking institutions. Traditional mortgage lenders and mortgage lending relationships are changing and creating significant uncertainty among competitors. The largest financial institutions are positioning to take advantage of the sweeping changes in the nation's banking laws to become financial services providers. Several of these financial conglomerates, once based in mortgage lending, consider themselves in competition with Fannie Mae and Freddie Mac. These financial services providers actively work to impede the GSEs growth and innovation in the marketplace with proposals that, if adopted, would be a torturous "death by a thousand cuts." The GSEs are being punished for their success, for doing what Congress directed.

These lenders lament not having the financial advantages that Congress granted to the GSEs and argue now for containing them. These financial companies are willing to argue that the Fannie Mae and Freddie Mac have an unfair advantage because of their federal charter ties. At the base of this lament and expressions of concern about the threat that the GSEs pose to the financial system, there is an unwillingness to admit that mortgage lending has changed significantly. The GSEs were created to do what no fully private company could or was willing to attempt. The price that Congress extracted from the GSEs for the federal charter and other benefits was to limit these enterprises to a single line of business. REALTORS® wonder if the lamenting financial institutions would give up their other lines of business in this grave new financial services world to do solely what Fannie Mae and Freddie Mac do with the constraints of the federal charter.

Casual observation alone would confirm that mortgage lending is significantly different now than from even five years ago. Mortgage loans are more a commodity than ever before, while mortgage funding and investment sources are more diverse. Even international mortgage investors are looking more closely to the U.S. housing finance model for emulation and investment purposes.

Today's mortgage marketplace is extremely competitive and changing at the speed of technology. Now improvements in technology are largely driving the primary and secondary mortgage markets. The impact of technology is not lost on REALTORS®. REALTORS® embrace the marriage of technology and the real estate transaction. Realtor.com and the developing real estate transaction with GMAC Mortgage, Fannie Mae, and other mortgage finance and real estate industry firms are a testament to how things have changed. REALTORS® are working with the GSEs to forge partnerships to use technology to speed the real estate transaction, lower origination and settlement costs, and open markets to creditworthy borrowers, many of whom were shut out by traditional underwriting and credit risk assessment practices as well.

REALTORS® and the GSEs

REALTORS® and homebuyers rely on the GSEs to provide liquidity in the mortgage marketplace. That is the essence of why Congress created these enterprises. In the nearly thirty years that Fannie Mae and Freddie Mac existed they fulfill their congressionally chartered mission in good economic times and in not so prosperous economic times. Despite this current

long economic expansion. REALTORS® know from painful experience that when the booming mortgage lending and real estate cycle will slow. Fannie Mae and Freddie Mac, unlike primary market lenders, will remain in markets during these downturns. REALTORS® also support the federal ties and subsidies that flow to the GSEs because of their federal charters. In exchange, the GSEs fulfill their charter obligations -- they do what Congress and homebuyers and most lenders want.

Despite REALTORS® general support for the GSEs, we do have our criticism of Fannie Mae and Freddie Mac. We strongly disagreed when the GSEs opposed increasing the FHA mortgage limits. REALTORS'® and the GSEs' positions divergence on increasing the FHA mortgage limits. It is likely that we will not agree in the future.

Another concern that the REALTOR® community has relates to the property disposition activities Fannie Mae and Freddie Mac. REALTORS® do not support Fannie Mae's and Freddie Mac's current efforts to expand their foreclosed property disposition activities to include bidding on third party foreclosed properties. We understand that licensed real estate agents are involved in the management and listing of these properties, though the limited inventory of real estate-owned of necessity narrows the number of REALTORS® who may broker and list these properties. As a part of their normal business activities, both GSEs have property disposition programs to dispose of properties acquired through foreclosure on mortgages held in portfolio. (These foreclosed properties are generally referred to as real estate-owned or REO.) Over the course of the past two years, both Fannie Mae and Freddie expanded these internal programs and contracted with banks to handle the disposition of bank-owned residential properties acquired through foreclosure.

Freddie Mac created its HomeSteps division to market its own and contracted REO properties. Many REALTORS® consider third party REO disposition as Freddie Mac's entry into the real estate brokerage franchise business.

Fannie Mae undertook a pilot program that successfully bid on a portfolio of properties seized by the U.S. Marshal's Office. In some cases, the seized properties included very expensive estates. Fannie Mae also contracts with several communities to manage and dispose of foreclosed properties.

In 1998, the California Association of REALTORS®, the largest state REALTOR® organization, investigated these new "third party" disposition programs. The primary concern raised was that many REALTOR brokerage firms that had traditionally provided disposition services for the banks were being forced out of this line of business as the result of their inability to compete with the GSE operations.

A working group of members and the leadership of the California association examined two questions: Is it appropriate for a federally chartered and subsidized entity like Fannie Mae or Freddie Mac to be competing with the private sector REALTOR firms when the properties involved were not the GSE's own? Is acting as a third party disposition firm an activity allowed by the GSE's federal charters or is it, as some alleged, a violation of the secondary markets federal charter?

The Association's Board of Directors concluded that the while the GSEs' disposing of their own portfolio of properties was appropriate, the third party operation was not. The third party REO activities are outside the GSEs' charters and the firms' secondary mortgage market mission. Consequently, the California Association spent the last eighteen months in talks with both enterprises in an effort to resolve the association's concerns. These discussions are ongoing.

The Federal Home Loan Bank System

REALTORS® do not have the same direct relationship with the Federal Home Loan Banks as with Fannie Mae and Freddie Mac. The Home Loan Bank System is a cooperative with broad lending mission rooted in the savings and loan industry as the principal source for mortgage and housing finance. We note, however, that the System's Mortgage Finance Program as an alternative to delivering mortgages into the secondary market via Fannie Mae and Freddie Mac. REALTORS® appreciate the Mortgage Finance Program as an additional source of funds for homeownership. The competition that the Home Loan Banks secondary market alternative provides to Fannie Mae and Freddie Mac may benefit mortgage lending and homeownership in the end.

ISSUES RAISED BY H.R.3703

Judging from the hearing record to date, if the objective of the bill was to generate controversy about the GSEs we must all conclude, "mission accomplished". As drafted, H.R.3703 is an extremely ambitious bill. The bill brings together several significant issues that could be addressed better in perhaps two or three stand-alone bills. In addition to consolidating GSE regulation under a single entity, the bill raises issues regarding the fundamental role the federal government should play in housing finance, the GSEs' mission, and the risks that GSE debt and securities may pose should there be a disastrous economic downturn.

H.R.3703 raises two extremely important questions that should be considered separately from GSE regulatory reform. The first is should Congress revise the GSEs' federal ties, mission and charter. The second question whether Fannie Mae and Freddie Mac may pose systemic risk to the financial system. The current GSE regulatory scheme reflects the historic roots of national housing policy, and a heightened awareness of the risks associated with the now highly sophisticated financing techniques that of the housing finance markets. The lessons learned in the wake of the savings and loan industry crisis of the late 1980s strongly influenced the current regulatory scheme.

GSE REGULATORY REFORM

Arguably, the current GSE regulatory framework for Fannie Mae and Freddie Mac, on the one hand, and the Federal Home Loan Banks, on the other, should be revised. The Department of Housing and Urban Development regulates Fannie Mae's and Freddie Mac's products and programs while overseeing the two enterprises' affordable housing goals performance. The Office of Federal Housing Enterprise Oversight administers with financial safety and soundness examinations and is nearing completion of the risk-based capital standard that once in place would ensuring that Freddie Mac and Fannie Mae maintain sufficient capital to be economically viable during economic downturns.

The Association believes that these oversight functions are the more appropriate mechanism for monitoring whether the GSEs are meeting their federally mandated mission without stifling innovation. Innovation in the mortgage delivery system has significantly reduced the transaction costs of homeownership and thereby assisted many households to own a home they previously would not have been financially able to buy.

We believe that Subcommittee should closely reexamine the Housing Finance Oversight Board as proposed by H.R. 3703. The Subcommittee's concentration on this aspect of the bill and creating a credible regulatory framework as a work product could be its fundamental contribution to building on the success of the secondary mortgage market and the federal role in housing finance.

If devising a new regulatory scheme for the housing GSEs becomes the principal focus of any proposed GSE reforms, there are some concerns that should be addressed. First, there are significant corporate and charter differences between the FHLBanks and Fannie Mae and Freddie Mac that need resolving. As the General Accounting Office indicated in a 1997 report responding to Rep. Richard Baker's request, the GSEs operate differently, but the risks they manage are similar.[5] An effective single regulator for these three GSEs would probably require revising the FHLBanks, its mission, and capital requirements to make them more like the other two housing GSEs. Second, regulatory reform should not result in a structure that effectively hamstrings the GSEs and leaves them vulnerable to cumbersome or burdensome oversight that stifles competition in the marketplace, reduces their effectiveness as mortgage investors, or makes them vulnerable to changes in the financial markets.

Finally, and probably most important, the proposed consolidated regulator must be independent. H.R.3703 seems to point in this direction by establishing an oversight board that includes presidential appointees and places the new regulatory body outside the federal appropriations process. Nevertheless, the experience with the Federal Home Loan Bank Board regulating the thrift industry regarding programs and safety and soundness should raise caution given the bill's proposal for configuring the new oversight board. We would recommend a new set of Subcommittee hearings to examine the oversight board proposal.

A final observation: The OFHEO risk-based capital standards should not be derailed or stymied in any new regulatory scheme. Though nearly seven years separate the establishment of OFHEO and the agency's bringing state of the art risk-based capital standards to the fruition, OFHEO is almost there. REALTORS® believe that much of the concern about the GSEs' systemic risk would be addressed when OFHEO's risk-based capital standards are in place.

OTHER ISSUES RAISED BY H.R. 3703

Congressional oversight of the GSEs' performance and a measured deliberate review of their mission are important undertaking. Congress created the housing enterprises to accomplish

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[5] Report to the Chairman, Subcommittee on Capital Markets, Securities and Government-Sponsored Enterprises, Committee on Banking and Financial Services, House of Representatives. Government-Sponsored Enterprises: Advantages and Disadvantages of Creating a Single GSE Regulator GAO/GGD-97-139. U.S. General Accounting Office, Washington, D.C., July 1997.

specific and, at the time, nearly revolutionary housing policy objectives. The current federal relationship with the GSEs is more than 20 years old and the residential secondary mortgage market is mature and efficient. The federal ties and charter issues are legitimate concerns for public debate and congressional review. It is appropriate for the Subcommittee to ask if the GSEs should have a new or continued role in the housing finance system. But it is our view that this review should occur against a background of what the GSEs do to promote homeownership and further refining the nation's housing finance system that is the envy of every country abroad.

There are several critical questions. Should Congress change the federal role in the nation's housing finance system? Should the federal subsidy that Fannie Mae and Freddie Mac receive as a result of the federal charter and related benefits are changed? What is the advantage of such change? What would our housing finance system be without Fannie Mae and Freddie Mac? How expensive would homeownership be without the federally mandated role of the GSEs? REALTORS® support the federal ties that current shape the GSEs. The secondary mortgage market works to the benefit of the mortgage lending industry, homeowners, and the nation's housing policy. The GSEs' never-used lines of credit to the Treasury may well be symbolic in today's capital markets. The other federal benefits that Congress gave to the GSEs are integral to the dynamics of the secondary mortgage market. Proposals to remove the lines of credit and to limit other GSE federal benefits to have real consequences for capital markets and for homeowners. REALTORS® believe that the lines of credit to the Treasury should not be removed or compromised.

GSEs' SYSTEMIC RISK

The question of whether Fannie Mae and Freddie Mac pose a systemic risk to the federal government and taxpayers is legitimate. Housing finance is risky, but profitable now given the secondary mortgage market. To contend otherwise simply ignores facts and begs the question: is this not what the nation and Congress want?

Clearly, there are risks should an economic downturn of any severity come about. It has happened before and that was why the GSEs were created. During the financial crunch of the '70s and '80s, the Fannie Mae and Freddie Mac stayed in markets when the private lenders and mortgage insurers left to limit their risk or moved away from housing finance into other investments to maintain income streams.

CONCLUSION

When Congress created Fannie Mae and Freddie Mac it set in motion a secondary market that evolved into a highly efficient, flexible system that is based on the premise that federally sponsored enterprises should be the engines that facilitate homeownership is a commonly shared value. Under changing economic conditions, the residential mortgage lending industry evolved to satisfy the needs of the market. Congress created the GSEs and empowered them to become critical intermediaries in the flow of consistent, affordable housing finance through the mortgage delivery system, and *de facto* regulators of the terms under which most mortgages are made.

Developments in the secondary mortgage market played critical roles in the advancement of mortgage liquidity and the reshaping of the nation's mortgage finance system. First, it forced the conformance of most underwriting, documentation and other essential terms of mortgage lending to the standards set by Fannie Mae and Freddie Mac. Conventional market mortgage pricing was directly tied to the capital markets, which assured greater price volatility and more reliable funding sources. Second, Fannie Mae and Freddie Mac created new investment products and facilitated a broader investor base for mortgages. Cash flows from a single pool of fixed rate mortgages could be structured in a variety of ways to suit investor needs regarding maturities and call protection. Finally, the technological tools needed for the development of these new securities, primarily computers and software that could perform a complex array of underwriting, pooling, structuring and pricing analyses, brought mortgage finance to a new level of sophistication.

The economic success and the function the GSEs serve have generally been unquestioned. First quarter 2000 homeownership rates pushed past 67 percent mark due in significant part to the activities of the GSEs. The appropriateness of government fulfilling this market function, however, continues to invite periodic attempts at controls and limitations. The challenge is devise reasonable rules of operation that maintain fiscal integrity without unduly hindering the operation of the national mortgage markets. Critics have charged that the GSEs are exceeding their federal charters' and have entered the primary mortgage market. These critics desire legislation that would specifically define secondary and primary market activities. Others charge that because of their size, the GSEs are a financial time bomb in the making, and stricter regulatory oversight is necessary. Still others charge that the GSEs are not meeting their legislative mandate of helping low and moderate-income households obtain homeownership.

REALTORS® urge the Subcommittee to back away from the rhetorical criticism of the GSEs. The physician's motto should be heeded as Congress considers dramatically reforms for the housing GSEs. "Do not harm" is an even more vital admonition should Congress fundamentally alter the federal ties that shaped the nation's secondary mortgage market and Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. REALTORS® cannot support removing the GSEs' lines of credit to the Treasury or otherwise limiting the federal ties of the GSEs. REALTORS® have vividly painful memories of how well meaning reform can have unintended consequences. The tax reforms of 1986 devastated the real estate industry. REALTORS® beseech this Subcommittee -- do no harm to the housing GSEs and the residential secondary mortgage market; they are integral to homeownership.

REALTORS® urge this Subcommittee to consider this principal question before embarking on sweeping changes affecting the GSEs. What will housing finance be like without the GSEs and a federal policy mission that seeks to broaden homeownership, deepen housing markets, reduce transaction costs, streamlines the process, empowers mortgage credit consumers, and integrates new products and financing options into the transaction. REALTORS® believe that this nation would not be nearly as well housed and homeownership aspiration could not satisfied to the extent that of the current homeownership rates without the housing GSEs backed by the federal charter and mission.

Statement of Christopher J. Sumner

President

Mortgage Bankers Association of America

Before the Subcommittee on
Capital Markets, Securities and
Government Sponsored Enterprises
of the
Committee on Banking and Financial Services

U.S. House of Representatives

July 20, 2000

Mr. Chairman, Congressman Kanjorski, Members of the Subcommittee, I appreciate the opportunity to testify before you today on the important issues raised by H.R. 3703. My name is Christopher J. Sumner. I am this year's President of the Mortgage Bankers Association of America,[1] the President and CEO of CrossLand Mortgage Corp of Salt Lake City, Utah, and a former member of the Board of Directors of Fannie Mae.[1]

The subject of this hearing is the current state of supervision and regulation of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks--Government Sponsored Enterprises or GSEs[2]— and the need for change. Mr. Chairman, I want to commend you and your Subcommittee for your leadership in tackling this long-range issue in a timely way – before any sudden or intense problem has occurred. In the area of safety and soundness, we are

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[1] MBA is an industry trade association of approximately 3,000 members, representing all facets of the real estate finance community, including independent and thrift- or bank-owned mortgage companies, banks, thrifts, credit unions, commercial banks, life insurance companies, mortgage brokers, and ancillary service providers.

[2] Unless otherwise indicated, future references to a GSE or the GSEs will refer only to Fannie Mae and Freddie Mac.

not facing "the perfect storm." By being proactive, you are clearly demonstrating a far-sighted approach to ensuring our nation's long-term economic security.

Allow me to begin my remarks with the MBA's "first principles." First: We believe Fannie Mae and Freddie Mac play an enormously important role in ensuring that this country has an adequate supply of affordable mortgage credit. They do this by providing needed liquidity in the residential mortgage market. We unequivocally want them to continue in this role.

Second: We believe that – to achieve the most efficient delivery of the lowest cost residential mortgage credit – there must be a robust and resilient primary mortgage market. Competition is key to the development of innovative products to meet borrowers' needs and to lowering borrowers' costs.

Third: We believe that, to uphold those first two principles, we need to assure effective oversight over the GSEs. Effective oversight will help deflect the arguments by those in favor of privatization as a means of addressing the issue of systemic risk. In addition, effective oversight will help to maintain the vitality and the robust nature of the primary market by preventing expansion of GSE activities beyond the intended boundaries of their Federal charters.

We believe the best way to keep our institutions tightly focused, and to ensure that we continue to have a robust primary market, is to clarify the boundaries of the GSEs' operations in more meaningful way than the GSEs' charters currently do. This is one area in which we believe the present bill can be improved upon. To that end, the MBA has convened a blue ribbon panel of mortgage company executives to examine the appropriate limits of secondary market activity and develop a workable definition. In a model of cooperation within the mortgage industry, Fannie Mae and Freddie Mac have agreed to participate with the MBA in a dialogue about the boundaries of the secondary market. Our goal is to produce a report with the MBA's views for review by Congress this fall.

<u>The Importance of Strong Primary and Secondary Mortgage Markets</u>

Our country currently enjoys the most successful residential mortgage finance system in the world. Through a unique private/public partnership, we have sustained a period of unprecedented housing opportunity. Borrowers routinely obtain long-term, fixed-rate mortgages at reasonable prices; apartment construction and modernization have increased. Of course, there is much more to do to realize the dream of safe and affordable housing for all Americans.

The MBA is pleased to be represented at this hearing today because of the role our members play in facilitating homeownership and rental housing. In order to sustain a viable secondary mortgage market, a robust and competitive primary market is essential. MBA is an industry association with approximately 3,000 members of the real-estate finance community, including independent and bank- or thrift-owned mortgage companies, banks, thrifts, credit unions, commercial banks, life-insurance companies, mortgage brokers, and ancillary service providers. In 1999, the primary market generated $1,287 trillion in single-family loans and $40 billion in multifamily loans.

The primary mortgage market is a vibrantly competitive market that rewards competition. Primary market lenders work to put families in homes and apartments. We must be responsive to consumers to stay ahead of competitors and stay in business. For example, the primary market developed adjustable rate mortgages that allow mortgagors to enjoy an interest rate that is lower than the rate available on fixed rate mortgages. In addition, the 80-10-10 mortgage allows borrowers to lower their monthly costs by eliminating the need for mortgage insurance. The borrower puts 10% down and obtains a 10% second mortgage and has an 80% loan-to-value mortgage. These products are examples of primary market lender creativity responding to the various needs and desires of consumers – and to the pressures of a competitive environment.

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In designing a housing policy, the Congress, in its wisdom, realized that, for the primary market to succeed in delivering affordable mortgage credit, a strong secondary mortgage market would be necessary. The Congress created the GSEs to smooth interest rates among regions and to provide dependable liquidity, particularly for single-family, long-term, fixed-rate mortgages. Mortgage bankers originate mortgages using sources of funding other than deposits. We sell our production into the secondary market to replenish our funds. Without a secondary market outlet, our production cycle stops. Fannie Mae and Freddie Mac are able and available to support mortgage bankers in the primary market – week in and week out. They buy our mortgages or securitize them, regardless of unpredictable factors. Their business is, specifically, buying and securitizing mortgages on a continuing basis.

The MBA steadfastly asserts the continued need for the GSEs to perform their liquidity function. Just as our members are the GSEs' customers, we have worked with both GSEs on developing and amending their Uniform Security Instruments; in developing various "open standards" for the electronic exchange of information; and in establishing an electronic registry, MERS, to help eliminate paper in the process of transferring mortgage rights. We developed with Freddie Mac English and Spanish guides to understanding credit scores, and, most recently, we partnered with two lenders and Fannie Mae to provide down-payment and closing-cost assistance to first-time homebuyers in Albany, New York – the first effort in what we hope will become a nationwide program.

Effective Oversight and Independent Funding of Regulators

Clearly, the two markets— the primary and secondary markets-- depend on each other. In fact, for a viable secondary mortgage market to exist, a robust and competitive primary market is essential. Therefore, while the MBA and our members are staunch supporters of the roles Fannie Mae and Freddie Mac play in providing liquidity, we believe the essential stability of the primary market would be undermined if the GSEs expand their activities beyond their intended mandate. The GSEs enjoy special statutory advantages that could permit them to leverage the strength they derive by statute from a two-party secondary market to dominate an extremely competitive primary one, upsetting the delicate equilibrium that Congress has established.

MBA is no new-comer to this issue. In 1999 at the request of our members, a special task force representing the broad spectrum of the MBA membership was convened to re-examine MBA's policy on the GSEs. Their efforts resulted in a new policy statement that was unanimously passed by our Board of Governors in August of 1999. A copy of the statement is attached to our testimony.

The MBA policy statement reflects the fact that the size, risk position and financial impact of Fannie Mae and Freddie Mac have grown enormously since their inception. MBA believes that the need for regulation of their activities has increased in direct relation to this growth. We also stated that pivotal areas of regulation include:

- their financial safety and soundness,
- the appropriateness of their activities in relation to their charters,
- their performance under their specific housing goals, and
- their effectiveness in fulfilling their mission.

We further believe that regulation of the GSEs must be independent and well-funded. It must be carried out by an entity, or entities, with the resources and expertise to evaluate the GSEs' performance, both as financial institutions and as public purpose entities. Such a regulatory structure must have the capacity to enforce its findings. Costs of this regulation should be fully funded by the GSEs themselves.

It is, therefore, consistent with our policy statement, that GSE funding of the HUD oversight operation, as well as that of OFHEO's, is necessary. It is also consistent that the funding of both HUD and OFHEO oversight functions be insulated from the Congressional appropriations process in the manner of the funding of the Office of Thrift Supervision and the Office of the Comptroller of the Currency. OFHEO is the only federal financial-institution regulator subject to the appropriations process. It may not be inappropriate, moreover, to move OFHEO to the Treasury Department, a concept that has just started to be discussed.

Resources for HUD's GSE oversight function currently come totally from the general HUD budget. As a result of budget constraints, HUD has only a few staff members fully dedicated to GSE oversight. Because of the lack of funding, additional staff members are pulled away from other functions to work intermittently on GSE issues. From a management perspective, the funding structure makes effective oversight very difficult, making recent initiatives particularly commendable.

<u>Need for Clarification of the Boundary of Fannie Mae and Freddie Mac Activities</u>

Blurring of the Primary and Secondary Mortgage Markets

The growing size of the GSEs is not the only factor that impels us to seek strengthened GSE regulation. We also see the delicate equilibrium between the primary mortgage market and the secondary mortgage market being upset. We believe that, if the balance is not righted, the long-term effect of current trends will be more costly mortgage credit for consumers. That will translate into a higher proportion of a family's budget going for housing, whether it be in the form of a monthly mortgage payment or rent.

Are we suggesting that there is systemic risk? No. We are talking about something altogether different. We are talking about the effects on competition in the primary market of both GSEs efforts to increase their market shares and increase returns to shareholders.

What is happening illustrates classic economic theory. It is a generally accepted principle in our modern economy that vigorous competition in the primary market among lenders generates maximum benefits for consumers. In the primary mortgage market, competition ensures not only lower mortgage costs but also more consumer financing options. To the extent that the GSEs are allowed to extend into the primary market the effects of the limited-competition model of their Federally chartered secondary market, consumers will be worse off since competition will be reduced.

Through conditions on the deployment of their technologies, through efforts to obtain market share by "branding" through advertising and otherwise, the GSEs are already having

a direct impact on primary market activities. In addition, by direct equity investment in non-lender primary market participants, both on and off the internet, the GSEs are positioning themselves potentially to have a profound impact on the competitive balance in the primary market.

The GSEs power to affect the primary market is derived from their market power in a secondary market that is not generated by a pure competition model. Their secondary market power is derived from the statutory advantages conferred by their Federal charters. The extraordinary market profits they achieve from their special Federal franchises make available greater resources for research and development than would be the case if the GSEs had direct competitors and did not enjoy their special advantages. Their resources for research and development are used to increase the GSEs' market share and continue the GSEs' market dominance. As their share of secondary-market activity increases to the point of domination, they might naturally turn to alternative arenas, including the primary mortgage market – indirectly if not directly – and the field of technology in general.

This drive of the GSEs to extend their reach is a natural outgrowth of the market structure created in their very origins. As we have stated, consumers benefit as the GSEs smooth interest-rate differentials across geographic regions and provide a source of liquidity to lenders in the primary market at a favorable price. We fully support these functions. Their pricing benefits flow through lenders to consumers from the special GSE advantages conferred by statute. However, the extension of the GSEs' powers into the primary market, either directly or indirectly, is the proper subject of Congressional scrutiny.

Although the GSEs' charter acts contain prohibitions against lending directly to borrowers and making interim loans to lenders (funding loans to borrowers), and various other restrictions on their activities— maximum loan limits and limitations on permitted credit enhancements, for example--the charter acts do not define the term "residential secondary mortgage market." That is the sphere of operation that the charter acts carve out for the GSEs. The introduction of such mortgage technologies as automated underwriting systems and the advent of the internet have greatly accelerated change in the mortgage industry and have intensified the need to resolve a central question: Where does the sphere of the GSEs

end? The fear is that when the GSEs— with their special statutory advantage--occupy an area, or when they put their resources behind other market entities, they ultimately become a significant, albeit not an exclusive, impetus for consolidation in the primary mortgage market. That consolidation arguably leads to fewer competitors, and ultimately to higher prices for consumers.

MBA believes that any policy debate on the activities of the GSEs should be focused on the distinct roles of public- and private-sector entities. We should not focus on the GSEs' roles in isolation. We should also consider the capacity of private markets to meet housing needs. Therefore, it is critical to MBA that:

- there be a clear separation between the roles of mortgage lenders and GSEs;
- GSEs be prohibited from engaging in any primary mortgage market activities, including the current statutory prohibition against the GSEs' providing or engaging in direct lending to borrowers; and
- mortgage lenders continue to originate and service mortgage loans, and maintain the market contact with their customers and vendors.

New Program Review Authority

We believe statutory guidance on the boundary of the "residential secondary mortgage market" would significantly facilitate the "new activity" review process of H.R. 3703. We believe it is sound policy to provide the GSEs and the appropriate regulator with additional guidance on how to evaluate GSE initiatives. Although, in some respects, flexibility and discretion are necessary, in other contexts, clear boundaries provide predictability, allowing both the regulator and the regulated entity to proceed more efficiently.

Moreover, on the subject of new activity review authority, we believe the present provision in the bill is overly broad and needs to be adjusted so as not to capture situations in which lenders propose mere "tweaks" to underwriting standards and other program requirements and other similar situations. These requirements are frequently modified to offer consumers a new product that the lender can then sell to a GSE on a negotiated basis. Safe harbors

from the notice and comment rulemaking must be established so that lenders may proceed to gain approvals from the GSEs for these kinds of negotiated products confidentially and speedily. Those products can then be brought to market without unnecessary delay. MBA does not want to stifle innovation on the part of lenders or the GSEs when the goal is placing more families into housing -- particularly those who are underserved.

Non-Mortgage Investments

Another subject related to the boundary of the GSEs' sphere of operations is oversight over their non-mortgage investments. We believe this is an appropriate area for Congressional inquiry.

Provisions of H.R. 3703 Inconsistent with the MBA Policy Statement

The special advantages the GSEs enjoy under their charters, including the ability of each GSE to ask the Treasury to provide a direct loan of up to $2.25 billion, were originally conferred by Congress to encourage the development of a viable secondary mortgage market. Many of the special advantages encourage the liquidity of mortgage investments, either directly or indirectly. The complex system of incentives Congress has established to foster housing and maintain liquidity and stability in the secondary mortgage market creates a delicate equilibrium. Removal of the so-called "line of credit" could upset that equilibrium, perhaps, introducing uncertainty into the capital markets. In the capital markets, uncertainty can bring about disruption. Accordingly, removal would be inconsistent with our policy statement.

For similar reasons, a statutory requirement for annual credit ratings also would be inconsistent with our policy statement. The goals of effective regulation are furthered so long as the GSEs' safety and soundness regulator, OFHEO, retains the discretionary authority to obtain credit ratings.

Before closing, Mr. Chairman, I would be remiss in talking about the primary market if I did not address the problem of predatory lending. Allow me to assert MBA's unequivocal

support for action to halt abusive lending practices. Predatory lending is a cancer on the industry. We are actively seeking a cure. MBA favors comprehensive reform and simplification of the mortgage process as a necessary means for eliminating abuses. We also support legislation to prevent abuses, aggressive enforcement of the law, necessary funding of enforcement agencies and new safeguards for consumers. MBA has published a seven-point plan that is appended to this testimony. Most lenders take great pride in helping families obtain affordable home financing, and they are committed to ending the abuses that have hurt too many.

With that said, Mr. Chairman, let me thank you for the opportunity to testify here today. The MBA looks forward to working with all interested parties in addressing the important issues at stake here. The MBA is committed to advancing home ownership and rental opportunities; to a robust and competitive primary market; and to a vigorous and effectively regulated Fannie Mae and Freddie Mac. I will now be happy to answer any questions.

MBA GSE Policy Statement

Preamble

The American public is served by a unique system of mortgage finance. This system results from a multifaceted Federal housing credit policy that teams Federal agencies and government sponsored enterprises with mortgage lenders, other insurers, conduits and investors in the mortgage market delivery system.

To advance the nation's housing goals, Congress created the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) (together the Government Sponsored Enterprises, or GSEs), along with the Federal Housing Administration and the Government National Mortgage Association, both parts of the U.S. Department of Housing and Urban Development (HUD); the Department of Veterans Affairs; the Rural Housing Service Administration; and the Federal Home Loan Bank System to fulfill specific objectives.

The MBA supports the vital role the GSEs play in maintaining and improving liquidity and stability in the secondary mortgage market. These secondary market enterprises generally, and their affordable housing activities in particular, are a significant part of America's housing and housing finance system.

MBA believes, however, that it is essential that the GSEs focus on the missions prescribed in their charters and that the clear distinction between primary and secondary market activities be reaffirmed. MBA is dedicated to preserving the primary market as the domain of a robust and competitive private sector, an essential factor in lowering the cost of homeownership.

Charter and Mission

The charters of Fannie Mae and Freddie Mac, as amended by the Federal Housing Enterprise Safety and Soundness Act of 1992, specify four broad purposes for the GSEs:

- to provide stability in the secondary market for residential mortgages;

- to respond appropriately to the private capital market;

- to provide ongoing assistance to the secondary market for residential mortgages (including activities relating to mortgages on housing for low-and moderate-income families involving a reasonable economic return that may be less than the return earned on other investments) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing;

- to promote access to mortgage credit throughout the Nation by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing.

The MBA acknowledges and supports the vitally important contribution the GSEs make in maintaining and improving liquidity and stability in the secondary mortgage market, including the role they play with their lender partners in achieving the affordable housing goals set forth by the U.S. Department of Housing and Urban Development.

GSE Special Advantages

To achieve the purposes outlined in their Charters, the GSEs have received from Congress significant special legal and financial advantages not available to other mortgage market participants.

These special advantages include:

- The GSEs are exempt from all State and local taxes except real property taxes.
- The GSEs may conduct business in any state or territory without the need to comply with any filing, licensing, or other business laws.
- The GSEs' securities enjoy the status of "Government Securities" and are, thereby, exempt from the registration, reporting requirements, and fees of the U.S. Securities and Exchange Commission and the States.
- The Secretary of the Treasury is authorized at the Secretary's discretion to provide direct government loans to each GSE of up to $2.25 billion.
- Debt Securities and mortgage-backed securities issued by the GSEs receive almost the same preferential investment status as Treasury debt. They can be used in many ways in lieu of U.S. Government Securities, for example as eligible collateral for advances from the Federal Reserve Banks for Federal Reserve open-market purchases and for collateralizing public deposits, in addition to being eligible for unlimited investment by federally supervised financial institutions.
- GSE securities are traded through the Fedwire system.
- The GSEs' debt securities and MBS receive more favorable risk weights than other mortgage loan assets for the purpose of calculating risk-based capital requirements for supervised depository institutions.

While there is no direct government guaranty of debt issued by the GSEs, investors in the capital markets assume an implicit guaranty, which provides Freddie Mac and Fannie Mae with the ability to borrow at advantaged rates.

The structure of Fannie Mae and Freddie Mac combines the advantages of Government Sponsorship status with the functional organization of a shareholder-owned Corporation. This structure, without effective independent oversight over their activities and the use of their special advantages, could lead to a conflict between the public purpose goals of the GSEs and their private sector goals of maximizing return to their shareholders.

MBA believes the special advantages that the GSEs receive should not be used to compete in the primary market or to expand into markets currently well served by others. Rather, they should be focused exclusively on maintaining liquidity and stability in the secondary mortgage market, as provided for in their charters, and on achieving their affordable housing goals.

Support for Maintenance of the Separate Roles of the GSEs and Mortgage Lenders

MBA believes that any policy debate on the activities of the GSEs should be focused on the distinct roles of public and private sector entities. We should not focus on the GSEs' role in isolation, but must also consider the capacity of private markets to meet housing needs. Therefore, it is critical to MBA that there be a clear separation between the roles of mortgage lenders and the GSEs.

MBA supports prohibition against participation by the GSEs in any primary mortgage market activities, including the current statutory prohibitions against the GSEs' providing or engaging in direct lending to borrowers. Mortgage lenders should continue to originate and service mortgage loans, maintaining the market contact with their customers and vendors, including but not limited to consumers, owners/developers of housing, brokers and other real estate professionals.

The GSEs should introduce new products and services only when they directly relate to their core functions of providing liquidity and stability in the secondary mortgage market, including activities relating to mortgages on housing for low and moderate income families.

Oversight and Regulation

The size, risk position and financial impact of Fannie Mae and Freddie Mac have grown enormously since their inception. MBA believes that the need for regulation of their activities has increased in direct relation to this growth. Focal areas of regulation should include: their financial safety and soundness, the appropriateness of their activities in relation to their charter, their performance under their specific housing goals, and their effectiveness in fulfilling their mission.

Regulation of the GSEs must be independent and well funded. It must be carried out by entity(s) with the resources and expertise to evaluate the GSEs' performance both as financial institutions and as public purpose entities. The regulator(s) must have the capacity to enforce their findings. Costs of this regulation should be fully funded by the GSEs.

In the ongoing review of their activities, particular attention must be paid to the issues of: 1) whether the activities of the GSEs have the effect of displacing or discouraging activities of private market entities that do not enjoy the special advantages that have been conferred upon the GSEs; and 2) whether their activities are consistent with the specific mandate of providing stability and liquidity in the secondary market for residential mortgages.

Guaranty Fees

Fees and charges collected by the GSEs from seller/servicers, including guaranty fees, are generally passed on to borrowers. Therefore, guaranty fees and other charges should be set at levels appropriate to protect the GSEs against the risks posed by the types of mortgages purchased, as well as guarantees and services provided, and to provide reasonable returns to shareholders in the context of their public mission.

Technology

In virtually every sector of our economy, technology has been a powerful and positive force for improving productivity, efficiency and accuracy in processing large amounts of information. In the housing finance market, the application of technology by a wide range of public and private sector participants has been a driving force in increasing opportunities for homeownership. To further expand these opportunities, the MBA supports the existence and development of an open, competitive marketplace for technology in order to achieve greater efficiencies and competition to benefit the entire marketplace.

MBA believes that to promote liquidity and efficiency in the mortgage markets:

- Any underwriting technology used by the GSEs should be transparent so the lending criteria of the GSEs are understood by their Seller/Servicers

- Aggregate and loan level performance data collected by the GSEs should be made available to their Seller/Servicers

To be consistent with their mission, the GSEs should not develop, distribute, or use technology in a way that:

- Bypasses their Seller/Servicers by going direct to the customers or vendors of those partners, including but not limited to consumers, owners/developers of housing, brokers, and other real estate professionals.

- Displaces or discourages innovation and development of competing systems by private enterprises.

- Limits access to their programs or is a precondition for waivers of representations and warranties or waivers of program and documentation requirements.

<u>User Fees</u>

MBA opposes the imposition on the GSEs of user fees that will increase the cost of housing in the primary mortgage market.

Capital Standards

MBA supports expanded liquidity for the residential mortgage markets by achieving the lowest possible risk-based capital standards for the GSEs and other federally-regulated financial institutions consistent with safety and soundness for participating institutions, stability for the overall market, and minimum exposure to the American taxpayers.

Affordable Housing Goals

MBA believes that the Affordable Housing Goals should be set at the numeric levels proposed by HUD. MBA believes that the definition of what counts toward the goals is an important aspect of the regulations which needs ongoing review. MBA believes that the continuation of a sub-goal for multifamily housing is appropriate and essential to assuring the GSEs' continued involvement in this market.

MBA also believes that the GSEs should accomplish these goals without cost or risk transfer to the primary mortgage market consistent with their statutory goal of "leading the market" and that these loans should provide a "reasonable economic return that may be less than the return earned on other activities."

TIMES UNION

Monday, June 26, 2000

EDITORIALS

Albany's national role

The city launches a pilot homebuyer program, while Troy gets more state jobs for its downtown

Ever since Americans began moving to the suburbs in droves, the cities have been left behind to struggle for their economic survival. More often than not, they have concentrated their efforts on luring new jobs to their industrial parks and downtowns, a strategy that remains popular even today.

But in recent years, there have been signs that instead of placing all of their economic hopes on jobs, the cities are beginning to realize that people matter, too. People who buy homes, repair and improve them and add to the city's tax base. Now comes a rare opportunity for Albany to prove this new theory on a national scale. Under a first-of-its kind program, Fannie Mae will join with the city of Albany and the Mortgage Bankers Association of America to provide low-cost loans of up to $5,000 to help home buyers come up with their down payments. Albany will contribute $100,000 in collateral, and two mortgage association members, FleetBoston Financial Corp. and HSBC, will each put up $75,000. Fannie Mae will match those contributions on a 4-to-1 scale, for a total of $1 million.

The program is expected to help some 250 first-time home buyers, with one-stop services and assistance available at a Central Avenue office called the Albany Home Store. A successful program will "strengthen the economic vitality of the city of Albany," observes Christopher J. Sumner, president of the mortgage bankers group.

The program's benefits are so apparent that it's puzzling why similar programs weren't begun nationwide long ago. One answer is that the jobs-equals-prosperity thinking still prevails. New jobs do help, to be sure. But workers often commute, while homeowners add to the city's tax base and count toward crucial census tallies.

In Troy also, the dual objectives of attracting homeowners and jobs continue to spur revival. As the new Albany program was making news, the city of Troy, coincidentally, was hearing more good news of its own as Governor Pataki and state Senate Majority Leader Joseph Bruno, R-Brunswick, announced that more state jobs would be coming to downtown soon. Even more welcome, the state Health Department workers who will be relocating will be occupying the former Stanley's Department Store, which has been vacant since 1989.

All this, plus hundreds of other state jobs that Senator Bruno has steered to Troy, warrants praise. But Troy Mayor Mark Pattison is also right to caution that an influx of jobs is no substitute for attracting new homeowners as well. That's because Troy, like all older cities, must cope with the urban problems of shrinking tax bases and steadily rising costs of maintaining basic municipal services.

Like Albany, Troy has a program – though different in scale and revenue sources – designed to lure homeowners back to the city, one that combines the Sage Colleges and Troy Rehabilitation and Improvement Program. In Schenectady, Union College is also reaching out to prospective homeowners in campus neighborhoods. In the short term, that means the cities are rebuilding their tax bases. In the long term, it means hope for the future.

DOWJONES
News Service

Friday, June 16, 2000

Fannie Mae mortgage group to unveil program for homebuyers

BY JANET MORRISSEY

NEW YORK (DOW JONES) - - Fannie Mae (FNM) is expected to unveil a pilot project next week in which the agency will team up with the Mortgage Bankers Association of America and the city of Albany, N.Y. to help people become homeowners.

Under the program, the three entities will jointly contribute up to $1 million in collateral, which will then be used to help cash-strapped home buyers with their down payments. Low-interest loans of up to $5,000 will be offered to home buyers to help with a down payment, said Todd Howe, vice president of corporate and member relations at the Mortgage Bankers Association.

This marks the first time the MBA has teamed up with Fannie Mae and a municipality for such a program, said Howe.

Albany is contributing $100,000 in collateral, and two members of the Mortgage Bankers Association – Fleet Bank, a unit of FleetBoston Financial Corp. (FBF) and HSBC (HBC) – are putting up $75,000 each in collateral. Fannie Mae is matching those contributions four-to-one for a grade total of $1 million. The city of Albany is issuing a note for $1 million and Fannie Mae has agreed to purchase it. Home buyers can access the loans through Fleet and HSBC.

Howe said the two-year pilot program is designed to help Albany lure residents back into the city's core as part of a revitalization and rebuilding plan. He said he expects other cities to follow suit, noting that he's already had inquires from cities in Colorado and Illinois about possibly launching a similar program.

The Mortgage Bankers Association, which includes mortgage companies, brokers and other lenders, had been looking to hook up with Fannie Mae for such a venture since last December, said Howe. Although many members of the MBA do business with Fannie Mae, as many of their mortgages are sold to the government sponsored enterprise, or GSE, this program allows communities to see the benefits directly.

It also allows MBA members to tap into Fannie Mae's partnership offices, which are set up around the country, he said.

With all the noise reverberating out of Washington about proposed overhauls to Fannie Mae and other GSEs, this program allows communities to see the benefits upfront, he said.

"It gets it out of Washington and into the backyards and communities where the people are," he said. "It helps the community. It helps home ownership and it helps the city."

Howe added: "It gives us an opportunity to be a model for (cities throughout) the country."

— *Janet Morrissey, Dow Jones Newswires, 201-938-2118*

AMERICAN BANKER

Wednesday, June 21, 2000

Fannie, MBA help first-timers meet initial costs

BY ERICK BERGQUIST

The City of Albany, the Mortgage Bankers Association, two banks, and Fannie Mae have teamed up to create a loan fund for first-time homebuyers to cover down payments and closing costs.

The program provides borrowers with second mortgages ranging from $2,000 to $5,000. To qualify, homebuyers must get a first mortgage on a home in Albany, either through a government homebuyer's assistance program or from a conventional lender.

Although the program is local and relatively small – Fannie is committing a total $1 million – Christopher J. Sumner, the president of the Mortgage Bankers Association, said he sees potential for developing similar programs in other cities.

"It's important that we can replicate it around the country," Mr. Sumner said. His trade group helped organize the Albany program.

Fannie will purchase a $1 million note issued by the Albany Community Development Agency. Proceeds from the bond sale will be used to fund the second mortgages.

Because the bond is unrated, the city contributed $100,000 and FleetBoston's Fleet Mortgage Group and HSBC USA Inc. kicked in $75,000 each as extra collateral. The city will administer the second mortgages. A Development Agency spokesman said it hopes to begin making the loans next month.

A Fannie Mae spokesman said Fleet or HSBC would originate the second loans and turn them over to a master seller-servicer to be selected by Albany. That seller-servicer would hold the loans and act as a trustee for the city, which in turn would pay Fannie.

The loans would be made through Albany Home Store, a homebuyer-counseling center that the city plans to open in the next few weeks. Mr. Sumner said that Home Store would educate homebuyers and help to protect them from predatory lenders.

The program is a response to rising housing costs, which have made homebuying more difficult for low- and middle-income families. However, the Albany program is not pegged to income; anyone may participate.

Mr. Sumner said the program will contribute to urban renewal by encouraging people to move back to the city from the suberbs. "There is a confluence of mayors committed to cleaning cities, creating attractive city core areas," he said.

Robert J. Levin, Fannie Mae's executive vice president, said Fannie has "been involved with about $100 million of down payment assistance" nationwide. However, this is the first program in which Fannie has partnered with the Mortgage Bankers Association, he said, and the first in which private lenders have shared the risk by putting up capital.

THE DAILY GAZETTE
The Independent Voice of the Capital Region

June 22, 2000

Large response in Albany to new home-loan program

BY JEREMY BOYER
GAZETTE REPORTER

ALBANY - In the two days after announcing a $1 million loan program to help first-time homebuyers, the city says it has been swamped with phone calls from interested participants.

By late Wednesday afternoon, more than 70 people had contacted the city Community Development Agency asking for information on the new program, which will provide first-time homebuyers with loans of $2,000 to $5,000 for downpayment and closing costs.

"There is a lot of interest out there, absolutely," said Frank Nemeth, the director of the Albany Home Store, the arm of the CDA that will administer the loan program.

The loan program announced Monday at Albany City Hall will be funded by the city, HSBC Bank USA, Fleet Bank and Fannie Mae. These organizations credited the Mortgage Bankers Association of America with bringing all of the participants together.

Albany will be the first of several cities throughout the United States to have the program, MBA officials said. The Albany program will be used as a model for the future cities, which should be announced by the end of the year.

The city of Albany expects to help 250 families buy their first homes within its borders. There are no income guidelines for the program.

Nemeth said interest rates for the loans are still being determined, but he said they should be kept low.

"It's a great opportunity," Nemeth said of the program. "Home ownership helps stabilize neighborhoods and the community."

The Albany Store is a city entity that will be opened on Central Avenue within the next three or four weeks. It will be a one-stop center for counseling and services for first-time homebuyers. The new loan program will be one function of the Albany Home Store.

Nemeth said applicants for the program should be available by mid-July at the latest. At this point, interested participants should contact the CDA at 434-5240.

"We'll give them a brief overview of the program over the phone," he said. "We'll add their name to a list of interested applicants and contact them when the program is ready to go."

REUTERS The Business of Information

12:30:26, 19 June 2000

MBA, Fannie Mae, lenders partner in mortgage plan

NEW YORK, June 19 (Reuters) - The Mortgage Bankers Association of America (MBA), two key mortgage lenders and Fannie Mae, the nation's largest source of financing for home mortgages, announced on Monday a new program aimed at helping first time homebuyers in Albany, N.Y.

The MBA, Fannie Mae, Fleet Bank and HSBC Bank USA have committed a total $1 million to help make home loans affordable through down payment and closing cost assistance, the MBA said in a press release Monday.

The City of Albany also invested $100,000, the MBA said. The program is the first in a series of such investments by mortgage lenders in cities around the country, the MBA said.

The home mortgage program, expected to serve 250 Albany first-time home buyers, will provide loans of between $2,000 and $5,000 for down payment assistance or closing costs in conjunction with obtaining a first mortgage under a state or local government home buyer's assistance program, or through conventional mortgage financing.

The MBA, which represents 3,100 mortgage companies, mortgage brokers, commercial banks, thrifts, life insurance companies and others in the mortgage lending field across the nation including Fleet Bank and HSBC Bank USA, worked with Fannie Mae over the past six months to develop and implement the public-private partnership.

The Albany program is expected to be a model for similar programs across the country, the MBA said.

Headquartered in Washington, D.C., the MBA is a national industry association representing the interests of residential and commercial real estate lenders, servicers and vendors.

THE DAILY GAZETTE
The Independent Voice of the Capital Region

June 17, 2000

Fannie Mae to aid Albany house buyers

BY JEREMY BOYER
GAZETTE REPORTER

ALBANY - Fannie Mae, the publicly owned Federal National Mortgage Association, will announce a new local program on Monday that could help hundreds of people purchase their first homes in the city by financing down payments and closing costs.

The program will create a public-private partnership involving two banks, the city and Fannie Mae. Officials directly involved in the program declined to discuss specific details on Friday, but said it is a new type of initiative for Fannie Mae.

Sources said the program would provide loans of $2,000 to $5,000 to help first-time home buyers in the city with down payments and closing costs. About $1 million worth of funding for the program would come from HSBC and Fleet banks, and from Fannie Mae.

"This is going to be a boon for certain people, young couples and others who haven't been able to build up savings yet," one official said. "The thing that prevents most people from buying their first home is not interest rates, it's typically down payment and closing costs. They just don't have enough money."

The program comes at a time when rising interest rates have boosted the costs of buying a home, and slowed home sales nationwide.

Further details of the program will be unveiled at a press conference at Albany City Hall on Monday morning. According to an advisory, the program is a joint effort of Fannie Mae, the Mortgage Bankers Association of America, HSBC, Fleet Bank and the city of Albany.

It was not clear Friday what role the city itself and the MBA will have in the program. Information on terms and interest rates for the loans was also not available.

Bringing first-time home buyers into Albany has been a priority for city officials, said George Leveille, commissioner for the Department of Development and Planning. "Home ownership is the basis for most of a family's equity," Leveille said. "Plus it brings stability to neighborhoods. People who own a home tend to have more of a vested interest in their neighborhood."

Leveille would not discuss specific features of the program to be unveiled on Monday. "I'll just say I think it's going to be real a positive thing for the city of Albany," he said.

A Fannie Mae official who asked not to be identified said the program is a new type of initiative for the company because of the number of partners involved. "This is not a typical kind of partnership," the official said.

Fannie Mae provides financial products and services to help low- to middle-income families throughout the United States to buy homes.

CAPITAL DISTRICT
BUSINESS REVIEW
On-Line Daily Edition

bizjournals·com
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14:45 EDT Monday June 20, 2000

$1M fund established to help first-time homebuyers in Albany

The City of Albany, Fleet National Bank, HSBC Bank USA and Fannie Mae have committed a total of $1 million to a fund to assist first-time homebuyers. The program, developed by the Mortgage Bankers Association of America, will provide loans of between $2,000 and $5,000 for downpayments or closing costs. It is open to anyone who purchases a home in Albany through the Albany Home Store, a new entity that provides counseling and services to help people become successful homebuyers.

TIMES UNION

June 20, 2000

FOR THE RECORD

Low-cost housing loans available in Albany

ALBANY - Low-cost loans of $2,000 to $5,000 for mortgage down payments and closing costs will be available to 250 first-time homebuyers in the city through a $1 million program funded by the city, Fleet Bank, HSBC, the Mortgage Bankers Association of America and Fannie Mae.

The city will administer the program and assist the buyers from the new Albany Home Store, which is to open soon on Central Avenue. For more information, call City Hall at 434-5240.

– Jo-Ann Johnston

CAPITAL DISTRICT
BUSINESS REVIEW

June 26 – July 2, 2000

$1M public-private loan fund to help Albany homebuyers

Fleet National Bank and HSBC Bank USA have teamed up with the Mortgage Bankers Association of America, the city of Albany and Fannie Mae to create a $1 million loan fund for first-time homebuyers.

The loan fund will work in conjunction with the Albany Home Store, a new entity scheduled to open in July, to provide counseling and other services to prospective homebuyers in Albany. People who purchase a house through the Home Store will be eligible for loans between $2,000 and $5,000 for a down payment or for closing costs.

The bulk of the $1 million came from Fannie Mae, the Federal National Mortgage Association. Albany invested $100,000 and Fleet and HSBC each put in $75,000. The Mortgage Bankers Association helped develop the initiative, which it is hoping to replicate in other areas.

Fleet, based in Providence, R.I., has 49 branches in the Capital Region. Buffalo-based HSBC has 24 area offices.

REAL ESTATE FINANCE TODAY

The Weekly Newspaper of The Mortgage Bankers Association of America

Volume 17/Issue 25 June 26, 2000

MBA in Affordable Housing Effort

For the first time, MBA helps coordinate lenders and GSE in a citywide program.

BY MICHAEL MURRAY
REFT STAFF REPORTER

For the first time ever, the Mortgage Bankers Association of America has coordinated private lender participation in an Albany, N.Y. affordable housing program

Fannie Mae and two mortgage lenders have committed to providing mortgages for first-time homebuyers, including downpayment and closing cost assistance

"This new loan program will enable hundreds of New York families to afford to buy a home, giving them added security and stability in their own homes while helping strengthen the economic vitality of the city of Albany," said Christopher Sumner, president of the MBA.

Fannie Mae has committed to finance the $1 million home mortgage program through its Down Payment Assistance Investment Note (DPAIN)

"It was a four-to-one match with Fannie Mae for the whole program," said Todd Howe, vice president, corporate relations at MBA. "But it was the first time that we were able to leverage more money by having private lenders."

MBA President Christopher Sumner announces new MBA affordable housing program in Albany, N.Y. Page 2

Since the program was announced, there have been more than 70 phone calls to Albany's city community and development agency asking about the program, according to MBA officials.

"The innovative downpayment assistance initiative, developed in partnership with the city of Albany, MBA, Fleet Bank and HSBC Bank USA, will provide the crucial funds needed to create more homeownership opportunities throughout Albany," said Robert Levin, executive vice president at Fannie Mae.

"For the first time, MBA and Fannie Mae have formalized a partnership to try to do some different innovative things in different areas," said Robert Bannister, director for the western and central New York partnership office for Fannie Mae. "Something is different from this downpayment assistance program than the ones we have done in the past few years with other mayors. MBA brought willing partners to the table in the form of two lending partners that posted collateral to help leverage this program for many more people."

MBA had encouraged Fleet Bank and HSBC Bank USA to get involved in the program and the lenders invested $75,000 each. At the same time, the city of Albany invested $100,000.

"Fleet invested in this unique partnership because of the positive impact on all concerned," said Michael Torke, president and chief operating officer of Fleet Mortgage Group, Columbia, S.C. "By working together, public and private entities can help strengthen cities and further promote economic development efforts."

David Hunter, president of HSBC Mortgage Corp., New York, pointed out, "This program represents a new partnership between HSBC, the MBA, Fannie Mae and the city of Albany. We are proud to be at the forefront of this initiative, which will help people achieve their dream of homeownership and help strengthen the Albany community."

The program will provide loans between $2,000 to $5,000 for downpayment assistance or closing costs in conjunction with obtaining a first mortgage under a state or local government homebuyer's assistance program or through conventional mortgage financing.

DPAIN will be available to anyone purchasing a home in Albany at all levels of income.

The city will market the Albany Home Store as the location to acquire DPAIN. The Home Store provides counseling and servi
to assist borrowers in purchasing a home

It is not a prerequisite to go through t
Home Store and its lenders, but MBA o
cials believe that most consumers will
there since that is where the Albany pl
to market the product.

"The Home Store and the MBA/F
nie Mae Albany DPAIN partnership
provide tremendous resources to Alba
homebuyers who need to secure lo
interest loans to finance the downpayme
and/or closing costs on a new home," sa
Albany Mayor Jerry Jennings. "Indivic
als who previously were unable to pu
chase a home because of limited financi
resources now have a real chance
homeownership."

The MBA has set up a general agre
ment with Fannie Mae to expand this pr
gram across the country.

While Fannie Mae has met with ma
ors in Rochester and Niagara Falls, th
MBA has set up joint meetings with th
U.S. Conference of Mayors and housi
and real estate agencies in Albany, Cha
lotte, N.C., Minneapolis and San Francisc
to further affordable housing policies.

The MBA, the U.S. Conference of May
ors and the Research Institute for Hou
ing America will be working on a repo
for January 2001 to present to the ne
Congress and White House ways in whic
the mortgage industry and cities can wor
together to promote affordable housing

The Premier Association of Real Estate Finance

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NEWS RELEASE

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MBA Urges Comprehensive Mortgage Reform, Releases 7-Point Plan

WASHINGTON (June 15)—The Mortgage Bankers Association of America (MBA) today released a seven-point plan for reforming the mortgage process and best practices guidelines to assist lenders working with subprime borrowers. MBA is urging Congress and the Clinton administration to include comprehensive mortgage reform as a key component of any action on predatory lending.

Said MBA President-elect Andrew J. Woodward Jr., "While it is absolutely essential that abusive lending practices be eliminated from the mortgage lending business, none of the efforts to do so will be successful without real and comprehensive mortgage reform. Simplification of the mortgage process will benefit all consumers and establish clear rules for lenders."

And, according to preliminary results from a survey commissioned by MBA and released today, consumers say simplification of the mortgage process would be the most effective way to raise confidence in and improve the mortgage lending experience.

The association's board of directors last week approved a mortgage-reform plan that calls for increasing disclosures to borrowers, simplifying the mortgage transaction, enhancing consumer education and counseling, requiring the use of fair lending practices, and increasing enforcement authority. The MBA plan calls for:

- Legislation to establish a "closing cost guarantee" program that gives consumers up-front closing prices. Lenders participating in the program would be subject to reformed disclosure requirements that would replace the Truth in Lending Act notices and front-end disclosures under the Real Estate Settlement Procedures Act.
- Increased disclosures to consumers, including a mortgage information booklet and a closing costs document that would include current rates and points, the guaranteed lender settlement costs, and an estimate of third-party costs.
- Legislation to prohibit enumerated improper practices and to impose penalties for engaging in those practices. MBA also is calling for a new system of remedies for consumers involved in mortgage transactions, including nationwide foreclosure reform.
- Vigorous enforcement of current federal and state consumer protection laws.
- Expanded counseling programs. MBA wants the Federal Reserve Board and HUD, in coordination with industry and consumer groups, to develop and support a uniform counseling program.
- Increased consumer education. MBA and the National Council on Economic Education have produced a classroom curriculum to teach school children about credit and to help them develop sound financial planning and management skills.

- Promotion of fairness and integrity in the mortgage process through adherence to MBA's best practices guidelines and support of HUD's fair lending initiatives.

MBA's call for mortgage reform comes as federal lawmakers and regulators have increased their scrutiny of subprime lenders and taken up the issue of "predatory lending." A U.S. Treasury/Housing and Urban Development Joint Task Force on Predatory Lending, of which MBA is a member, recently held hearings around the country to study the practice in which borrowers—usually individuals with blemished credit reports or spotty employment, so-called subprime borrowers—have been charged excessively high fees or have been subjected to deceptive actions.

"We intend to work aggressively to ensure that any legislative or regulatory approach to predatory lending include comprehensive mortgage reform as a key component," said John Courson, MBA vice president-elect, who led the development of MBA position's on comprehensive mortgage reform.

Added Henry V. Cunningham Jr., a member of MBA's board of directors who represents state and local mortgage bankers associations, "The MBA proposal for comprehensive mortgage reform lays the foundation for one set of rules—a set of rules that will protect and empower consumers and at the same time provide clear guidelines for compliance and enforcement."

In a separate statement, John E. Taylor; president and CEO of the National Community Reinvestment Coalition, said, "NCRC applauds the Mortgage Bankers Association for its leadership in calling attention to the serious problem of predatory lending. MBA's call for reform and simplification of the mortgage process is an important and valuable first step in addressing the abuses that are suffered by many families. NCRC looks froward to forward to working with MBA, Congress, regulators, the GSE's and the entire lending industry and our members to stop these abuses."

MBA and the NCRC will team up to provide financial literacy training in communities across the country.

MBA's best practices guidelines, also released today, serve as standards by which its members should meet their business goals and objectives while dealing fairly and equitably with consumers. Member companies that adopt the guidelines agree to annual recertifications by credible independent third parties.

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MBA is the national association representing the real estate finance industry. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership prospects through increased affordability; and to extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters excellence and technical know-how among real estate finance professionals through a wide range of educational programs and technical publications. Its membership of approximately 3,100 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, life insurance companies and others in the mortgage lending field. For additional information, please visit MBA's website: www.mbaa.org.

ALBANY PRESS RELEASE

For Immediate Release

Contact: Jo Ann LeSage, APR
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MORTGAGE BANKERS ASSOCIATION OF AMERICA, FANNIE MAE AND LENDERS VOW $1 MILLION FOR NEW HOME MORTGAGE PLAN; LENDERS TO PROVIDE DOWN PAYMENT ASSISTANCE THROUGH LOAN FUND

Mortgage Bankers Association of America, Fannie Mae and Key Lenders Announce New Program for City of Albany

ALBANY, New York (June 19, 2000) – In a unique partnership announced today, the Mortgage Bankers Association of America (MBA), two key mortgage lenders and Fannie Mae (FNM/NYSE), the nation's largest source of financing for home mortgages, committed their own capital to help make home loans affordable through down payment and closing cost assistance. These partners pledged $1 million for a new program in the City of Albany aimed at helping first-time homebuyers.

The program – the first in a series of such investments by mortgage lenders in cities around the country – was announced today at a City Hall news conference by Albany Mayor Jerry Jennings, MBA President Christopher J. Sumner, Fannie Mae Executive Vice President Robert J. Levin, and top executives of Fleet Bank and HSBC Bank USA.

Mayor Jennings hailed the program as "a great investment for the people of America's cities and for the citizens of Albany."

"This new loan program will enable hundreds of New York families to afford to buy a home, giving them added security and stability in their own homes while helping strengthen the economic vitality of the City of Albany," said Christopher J. Sumner, president of the MBA. "By helping more families achieve 'the American dream' of homeownership, this well-financed program will help expand their economic opportunity and give them the sense of pride in homeownership."

MBA, FANNIE MAE, KEY LENDERS ANNOUNCE NEW PROGRAM

The home mortgage program, expected to serve 250 Albany first-time home buyers, will provide loans of between $2,000 and $5,000 for down payment assistance or closing costs in conjunction with obtaining a first mortgage under a state or local government home buyer's assistance program, or through conventional mortgage financing.

Financing for the $1 million home mortgage program was made possible through a commitment from Fannie Mae through its Down Payment Assistance Investment Note (DPAIN). The City invested $100,000, and mortgage bankers Fleet Bank and HSBC Bank USA each invested $75,000 in the DPAIN. Fannie Mae's DPAIN is used to create a readily available loan fund, administered by the City, which consumers can use for down payment and closing cost assistance.

DPAIN will be available to individuals of all income levels who purchase a home within the City through the Albany Home Store, to be opened in the next few weeks on Central Avenue. The Albany Home Store will provide a one-stop location for comprehensive counseling and services to assist individuals in becoming successful homebuyers in the city. It will also offer a variety of city and community partners' products and Internet resources detailing programs available to individuals attempting to purchase a home in the city.

"The innovative down payment assistance initiative, developed in partnership with the City of Albany and the Mortgage Bankers Association's local lenders Fleet Bank and HSBC, will provide the crucial funds needed to create more homeownership opportunities throughout Albany," said Robert J. Levin, executive vice president, Fannie Mae. "Saving for a down payment can be one of the main barriers to homeownership. Today's announcement is part of Fannie Mae's commitment to support our mortgage lender partners as they help consumers reach their dream of homeownership."

MBA, FANNIE MAE, KEY LENDERS ANNOUNCE NEW PROGRAM

Albany Mayor Jerry Jennings said, "The Home Store and the MBA/Fannie Mae Albany DPAIN partnership will provide tremendous resources to Albany home buyers who need to secure low-interest loans to finance the down payment and/or closing costs on a new home. Individuals who previously were unable to purchase a home because of limited financial resources now have a real chance at homeownership."

David Hunter, president of HSBC Mortgage Corporation (USA), a subsidiary of HSBC Bank USA, said, "This program represents a new partnership between HSBC, the MBA, Fannie Mae and the City of Albany. We are proud to be at the forefront of this initiative, which will help people achieve their dream of homeownership and help strengthen the Albany community."

"Fleet invested in this unique partnership because of the positive impact on all concerned—the City of Albany, its residents and the business community," said Michael J. Torke, president and COO of Fleet Mortgage-a FleetBoston Financial company. "By working together, public and private entities can help strengthen cities and further promote economic development efforts."

The new financing for the affordable-housing program comes at a moment when the rising cost of housing is putting homeownership further beyond the reach of many Americans, especially in urban centers. Last week, U.S. Secretary of Housing and Urban Development Andrew M. Cuomo released his department's fourth annual "State of the Cities" report, which focused in part on rising housing costs: Home prices are rising so fast in many cities that lower- and middle-income families can no longer afford to buy a house or even rent an apartment.

MBA, FANNIE MAE, KEY LENDERS ANNOUNCE NEW PROGRAM

"The MBA, Fannie Mae and the City of Albany should be commended for creating this unique new program," said Peter Staniels, president and co-owner of Noreast Real Estate Group and president of the Greater Capital Association of Realtors. "This partnership will be great for the home buyers of Albany – as well as the realtors – and will act as a stimulus in revitalizing the housing sector of the city."

The MBA, which represents 3,100 mortgage companies, mortgage brokers, commercial banks, thrifts, life insurance companies and others in the mortgage lending field across the nation including Fleet Bank and HSBC Bank USA, worked with Fannie Mae over the past six months to develop and implement this unique public-private partnership. Albany's program will serve as a model for communities across the nation. Mr. Sumner expects that several other programs will be announced before the end of the year.

# # #

Headquartered in Washington, D.C., the ***MBA*** *is a national industry association representing the interests of residential and commercial real estate lenders, servicers and vendors. The MBA works to ensure the continued strength of the nation's residential and commercial real estate markets, to expand homeownership prospects through increased affordability and to extend access to affordable housing to all Americans. The MBA promotes fair and ethical lending practices and fosters excellence and technical know-how among real estate finance professionals through a wide range of educational programs and technical publications, and through its Code of Ethics and Standards of Practice.*

MBA's membership of approximately 3,100 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, life insurance companies and others in the mortgage lending field.

Fannie Mae *is a New York Stock Exchange company and the largest non-bank financial services company in the world. It operates pursuant to a federal charter and is the nation's largest source of financing for home mortgages. Over the past 31 years, Fannie Mae has provided nearly $2.8 trillion of mortgage financing for over 34 million families. More information about Fannie Mae can be found on the Internet at http://www.fanniemae.com.*

Statement of Bruce C. Smith
on behalf of the
National Association of Home Builders

Regarding H.R. 3703,
"The Housing Finance Regulatory Improvement Act of 2000"

Before the Subcommittee on Capital Markets, Securities and
Government Sponsored Enterprises,
Committee on Banking and Financial Services

United States
House of Representatives

Washington, DC
July 20, 2000

Mr. Chairman, I am Bruce C. Smith, a home builder from Walnut Creek, California. I am President of Smith Quality Homes, a family owned business in existence for 65 years. Today, my brother, Randy and I run our business which has diversified into remodeling, light commercial construction and property management. I am also First Vice President of the National Association of Home Builders (NAHB), whose 200,000 members I am pleased to represent today.

NAHB appreciates this opportunity to present its views on H.R. 3703, "The Housing Finance Regulatory Improvement Act of 2000." Mr. Chairman, NAHB shares your desire to ensure a strong, independent, and effective regulatory structure for the housing-related government-sponsored enterprises (GSEs), Fannie Mae, Freddie Mac and the Federal Home Loan Bank System. We also support your efforts to assess whether the present regulatory structure for these GSEs is working effectively and efficiently to ensure that these institutions are operating in a safe and sound manner and fulfilling their public missions.

NAHB believes that the current regulatory structure is accomplishing these objectives. America's housing finance system works very well and, indeed, is the envy of the world. Much of this success is due to the public/private partnership established by Congress more than a half-century ago and to the reforms enacted in the Federal Housing Enterprises Safety and Soundness Act of 1992 (the GSE Act) as well as the Gramm-Leach-Bliley Act passed just last year. This is not to say, however, that the current housing finance system is perfect. Indeed, several sectors of the housing market remain underserved by the present system. Until these gaps are filled, we cannot afford to be complacent. There is more work that the GSEs can and should be doing to expand homeownership opportunities to all Americans and to support the markets for affordable rental housing.

H.R. 3703 takes a two-track approach aimed at improving the regulation of the GSEs and changing their relationship to the federal government. The first track would consolidate the regulation of the housing GSEs into a new independent agency. The second track makes a number of changes to the GSEs' charters with regard to GSE status. While NAHB is receptive to proposals that would improve the efficiency of GSE regulation, we are concerned that several provisions of H.R. 3703, particularly those relating to the regulator's authority and changes to GSE status, would disrupt the smooth operation of the US housing finance system by undermining the ability of the GSEs to provide liquidity and lower-cost financing, ultimately raising the cost of homeownership and rental housing. The implementation of such proposals would unravel much of the progress we have made to date.

I. GSEs Play A Critical Role In Sustaining The U.S. Housing Finance System

The housing-related GSEs, Fannie Mae, Freddie Mac and the Federal Home Loan Bank System (FHLBank System), were created by Congress to play an integral role in federal housing policy. Since their creation, the GSEs have evolved into extremely critical components of this nation's housing delivery system. That we have become the best housed nation in the world is due in large part to the contributions of the housing GSEs. With the help of the GSEs, the national homeownership rate reached an all-time high of 67.1 percent in the first quarter of this year.

Through their Congressional charters, the GSEs receive several federal privileges and legal exemptions to assist them in achieving their national goal of increasing the availability of financing for housing. These federal privileges or attributes include:

- a line of credit with the US Treasury of up to $2.25 billion each for Fannie Mae and Freddie Mac, and $4 billion collectively for the Federal Home Loan Banks;
- eligibility for the GSEs' corporate securities to be purchased without limit by federally regulated financial institutions;
- assignment of mortgage-related securities issued or guaranteed by the GSEs to the second lowest credit risk category at insured depository institutions;
- eligibility of the GSEs' debt to serve as collateral for public deposits;
- eligibility of the GSEs' securities for Federal Reserve open market purchases;
- exemption from state and local income taxes (but not from property taxes or federal income taxes);
- exemption from SEC registration requirements.

Securities issued by the GSEs are not explicitly guaranteed by the U.S. government. However, given their federal privileges, the marketplace has assumed an implicit government guarantee. Concerns that the outstanding liabilities of the GSEs could become contingent liabilities of the U.S. government prompted steps in 1992 to strengthen the regulatory oversight of the GSEs. The 1992 Federal Housing Enterprise Safety and Soundness Act (the GSE Act) reaffirmed HUD as the programmatic regulator of Fannie Mae and Freddie Mac; established a new safety and soundness regulator for Fannie Mae and Freddie Mac, the Office of Federal Housing Enterprise Oversight (OFHEO), as an independent agency within HUD; and reaffirmed the Federal Housing Finance Board (FHFB) as the regulator of the FHLBank System. Last year's passage of the Federal Home Loan Bank System Modernization Act of 1999 (the Modernization Act) as part of the Gramm-Leach Bliley Act will further strengthen the oversight of the FHLBank System.

The GSEs are American success stories. Together, they have brought enormous benefits to home buyers and the housing finance system. Let me review some of the benefits provided by the housing GSEs.

Reduction of mortgage interest rates

Home buyers with conforming loans -- mortgages eligible for purchase by Fannie Mae and Freddie Mac, those up to $252,700 for one-unit properties -- pay mortgage rates that are approximately 25 to 50 basis points lower than rates paid by other conventional mortgage borrowers. This fact was substantiated in the 1996 studies by the General Accounting Office, the Congressional Budget Office, HUD and the Treasury Department. Further evidence is provided in the mortgage rates reported weekly in the Wall Street Journal. For example, on July 7, rates on conforming mortgages were about 25 basis points lower than those on jumbo mortgages.

Reliable and stable supply of mortgage credit

The vibrant and efficient secondary market that the housing GSEs have been instrumental in establishing provide a link to the national and international credit markets. This linkage sustains the flow of capital to housing, even under changing economic conditions. While the economy has undergone major shocks over the past decade, home buyers have experienced no interruption in the availability of mortgage credit. As evidence of the stable flow of credit for housing, one only needs to look to the financial market liquidity crisis in late 1998, when the GSEs continued to make a wide variety of home and multifamily mortgage products available at affordable interest rates.

Elimination of regional disparities in interest rates

The GSEs provide a nationwide market for mortgage funds, a key factor in the elimination of regional disparities in the availability and cost of mortgage credit, which occurred regularly before Fannie Mae and Freddie Mac came on the scene. Today, interest rates in conforming mortgage markets around the country vary by no more than 10 basis points.

Cushion against local economic downturns

When regional economies begin to slow, some participants in the mortgage industry have restricted credit or abandoned markets in search of opportunities elsewhere. This is not the practice of the GSEs. They maintain a presence in all markets under all economic conditions, cushioning the impact of local or regional declines in economic activity. For example, the GSEs helped support housing prices in Texas during the collapse of oil prices in the 1980s, and they helped to counter weak markets in the Northeast and in California in the early 1990s.

Expansion of homeownership and rental housing opportunities

The housing GSEs have made significant strides in expanding homeownership opportunities and increasing the supply of affordable rental housing in underserved areas. The housing goals enacted by the 1992 GSE Act have successfully encouraged both Fannie Mae and Freddie Mac to significantly increase their service to the market sectors targeted by the housing goals. Fannie Mae's and Freddie Mac's financing of housing for low- and moderate-income families has increased from under 30 percent of their mortgage purchases in 1992 (just before the housing goals were established) to about 45 percent in the last few years. Since the initial housing goals were established in 1995, both of these GSEs have exceeded all of their housing goals. Moreover, both Fannie Mae and Freddie Mac have committed to reaching the new higher goals recently proposed by HUD. NAHB has submitted comments to HUD in support of the higher goals, and we commend Fannie Mae and Freddie Mac for their commitment to reach these new stretch goals.

These accomplishments are the result of concerted efforts by both Enterprises in the affordable housing arena. Both GSEs have introduced products and services to expand homeownership opportunities for low-and moderate-(low/mod) income borrowers, renters and residents of areas underserved by the broader housing finance system. Technological

innovations by the GSEs, such as their automated underwriting systems (AUS), also have contributed to their efforts to expand homeownership opportunities. In the affordable multifamily market, both GSEs have established forward commitment programs that support much-needed production of new units. Further, each has developed partnerships and alliances at the national and local levels to expand affordable housing opportunities. Several of NAHB's local Home Building Associations have worked with Fannie Mae and Freddie Mac on these partnerships.

The Federal Home Loan Bank System also has been a leader in supporting targeted housing and community development. The Affordable Housing Program (AHP) was established in 1989 to subsidize the interest rates for advances (loans) and to provide direct subsidies to FHLBank System member institutions engaged in targeted lending for long-term, owner-occupied and affordable rental housing. The Community Investment Program (CIP), also established in 1989, is a targeted housing and economic development loan program that supports home purchase and rehabilitation as well as commercial and economic development activities. CIP funds are available as advances to member institutions.

Market standardization and innovation

The GSEs have brought both standardization and innovation to the mortgage markets, involving a variety of mortgage instruments and securities structures. Standardization is key to obtaining and retaining investor confidence and supports the innovation that has addressed a broad range of borrower and investor preferences.

In the primary market, the GSEs have supported the development of hybrid mortgages that combine the benefits of adjustable and fixed-rate mortgages. The GSEs also have established reduced downpayment programs to help cash-strapped first-time home buyers. Recently, both Fannie Mae and Freddie Mac have introduced mortgage products to assist borrowers with tarnished credit histories.

In addition, Fannie Mae and Freddie Mac are at the forefront of technological innovations to streamline the mortgage process in order to reduce the time and cost involved in obtaining a mortgage. The GSEs automated underwriting systems (AUS) have fundamentally changed the mortgage origination process and have significantly reduced origination costs. The AUS technology also has allowed the GSEs to expand the scope of their mortgage products and extend homeownership opportunities.

The GSEs' innovations have not been limited to the primary mortgage market. In the secondary markets, Fannie Mae and Freddie Mac have launched a continuing chain of breakthroughs, such as collateralized mortgage obligations, which have allowed mortgages to be "repackaged" to attract new groups of investors. On the funding side, the GSEs recently have pioneered new debt products to meet the demands of global investors. These innovations have allowed the GSEs to expand the investor base for US mortgage securities worldwide, bringing greater liquidity to the US mortgage market and, ultimately, reducing costs for the nation's homebuyers and renters.

The Federal Home Loan Bank System also has developed important financing innovations. In 1997, the System authorized the FHLBank of Chicago to establish a pilot called the Mortgage Partnership Finance (MPF) program. Subsequently, the Finance Board gave all FHLBanks the authority to engage in the MPF. Under the MPF, the FHLBank funds the home mortgage loan while the member institution retains all functions involving the customer relationship including marketing, origination and servicing. NAHB supports the MPF, as well as other FHLBank System efforts to expand beyond traditional advances products, that result in lowering mortgage costs for home buyers. We also support the Finance Board's removal of dollar limits on the MPF program as a part of its regulation on core mission activities.

Most importantly, the GSEs have provided these benefits at no cost to taxpayers. The GSEs' business operations are fully self sufficient. Furthermore, taxpayers are protected from risk by the GSEs' prudent risk management. Governmental studies released in 1991 found that the GSEs' did not pose undue risk to the government. These findings were re-affirmed by the 1996 governmental studies noted above. New rigorous and dynamic risk-based capital standards currently being developed by OFHEO for Fannie Mae and Freddie Mac will provide additional protection for the taxpayers. NAHB has supported OFHEO's efforts in this area. Finally, as mandated by last year's Modernization Act, the capital structure of the FHLBank system is being revised for the first time in nearly 70 years, and this revision will include risk-based components.

II. Continued GSE Support Is Essential To Address Unmet Housing Needs

Despite the many achievements of the housing finance system over the past several years, and the current record homeownership rate, there are still many underserved sectors of the housing market. Homeownership rates for minorities and certain other segments of our population remain low. In the first quarter of this year, homeownership rates for African-Americans and Hispanics were 47.8 and 45.7 percent, respectively, compared to 73.4 percent for whites. Although homeownership rates for both African-Americans and Hispanics have increased significantly since the early 1990s, from a low of 42 percent in 1993 for African-Americans and 39 percent in 1991 for Hispanics, the disparity between minority and white homeownership rates remains wide. For example, the gap between homeownership rates for African-Americans and whites has declined from 28.2 percentage points in 1993 to 25.6 today. Similarly, the gap between white and Hispanic homeownership rates has decreased from 30.5 percentage points in 1991 to 28 percentage points. For both groups, the gap with whites has narrowed by less than 3 percentage points. Clearly more work remains to be done.

Nevertheless, some would argue that the housing GSEs have fulfilled their Congressional mandate, that the GSE status of these companies is no longer needed and is an unnecessary diversion of resources into housing. Indeed, Federal Reserve Chairman Alan Greenspan stated as much in his recent letter to Chairman Baker. We take exception with this view and have expressed our concerns to Chairman Greenspan. (A copy of our letter to Chairman Greenspan is attached.) Until all Americans enjoy decent and affordable housing, as well as the opportunity for homeownership, the critical supports provided the GSEs to the housing finance system should not be weakened.

The GSEs' continuing role in providing capital for the secondary markets is critical to filling these gaps in the housing finance system. As noted above, the GSEs have made significant strides in expanding homeownership opportunities through their many affordable housing initiatives. Several of these initiatives are also targeted at narrowing the minority/white homeownership gap through partnerships, expansion of low-downpayment mortgages and more flexible underwriting.

Further, we commend the GSEs for their recent forays into the subprime mortgage market, which serves primarily lower-income and minority homebuyers. Some, primarily private-sector competitors of the GSEs, believe the GSEs should not be in the subprime market. They view these activities as beyond the scope of the GSEs' Congressional charters. We disagree with this assessment and encourage the GSEs to bring the benefits of standardization and lower costs to the subprime market in the same way they have benefited the conventional mortgage market. We also note that HUD, through the proposed increases to the GSE affordable housing goals, is encouraging the GSEs to increase their participation in this market.

Moreover, we believe the GSEs have been proactive in addressing the issue of predatory lending. Both Fannie Mae and Freddie Mac have recently adopted guidelines to address predatory lending. We believe that these actions will prevent the purchases of predatory mortgages by these GSEs and thus obviates the need for this issue be addressed either through legislation or regulation.

III. Key Issues Raised By H.R. 3703

In dealing with both the regulatory framework and the status of the GSEs, H.R. 3703 raises key issues for the housing finance system. Given the critical supports the GSEs provide for housing finance, these changes could have significant consequences affecting the cost of housing for America's home buyers and renters. We commend the Subcommittee for holding a series of hearings such as this one to fully consider the impact of the proposed changes on the housing finance system. NAHB will confine its comments on H.R. 3703 to three provisions in the bill: consolidation of regulatory oversight; changes to the approval process for new activities; and, elimination of the GSEs lines of credit with the Treasury.

Consolidation of Regulatory Oversight

Title I, Section 101 creates a single regulator, a separate agency within the executive branch, for all housing GSEs called the Housing Finance Oversight Board. This Board would serve as the safety and soundness and mission regulator for the GSEs. In so doing, the board would assume all the regulatory authority exercised by the Federal Housing Finance Board over the twelve regional Federal Home Loan Banks, and by HUD and OFHEO with respect to Fannie Mae and Freddie Mac.

As stated earlier, NAHB supports a strong and efficient regulatory system for the GSEs, one that balances safety and soundness concerns with mission fulfillment. We believe that the current GSE regulatory system meets these objectives. However, we are willing to participate in efforts to examine changes to improve the current system. In this process, great care should be

taken not to impair important regulatory efforts underway or the ability of the GSEs to attract capital to the housing finance system.

For example, there should be no unnecessary delay in publication of final of risk-based capital regulations for the GSEs. Implementation of such capital standards should be the highest priority to ensure the safety and soundness of the housing GSEs. We note that OFHEO is close to finalizing its risk-based capital rule applicable to Fannie Mae and Freddie Mac. This rule promises to be the toughest and most sophisticated of capital regulations in the financial services industry. NAHB has submitted comments to OFHEO in support of such a capital structure and we commend OFHEO for its work thus far. In the case of the FHLBanks, work has just begun on revisions to the System's capital structure mandated by last year's Modernization Act. It is important that any consideration of restructuring the GSE regulatory framework not interfere in the development of these rules.

Review of New Activities

Section 110 of H.R. 3703 revises the approval process for new GSE activities. Currently, HUD is required to review new programs for Fannie Mae and Freddie Mac to ensure they are consistent with these GSEs' Congressional charters and are in the public interest. The Federal Housing Finance Board performs a similar function for the Federal Home Loan Banks. Under Section 110, the new Housing Finance Oversight Board would be required to "promptly" publish a notice of a new GSE activity in the Federal Register for a comment period of not less than 30 days. The Board would determine if the initiative was specifically authorized by the GSEs' charter and would also be required to conduct a cost-benefit analysis to determine if the activity was in the public interest, defined as those where the public benefits exceed the public costs. New activity requests would be required to be approved generally within 90 to 120 days of publication in the Federal Register.

NAHB strongly believes that the GSEs should always operate within their Congressional charters. As noted above, some market participants are concerned that the GSEs are expanding beyond the scope of their charter. Section 110 presumably would address such "charter creep" concerns. However, we are concerned that the approval process envisioned in H.R. 3703 could adversely effect the housing finance system.

NAHB believes that the GSEs have effectively identified market needs and responding efficiently. We fear that Section 110 would subject the GSEs to an unnecessarily cumbersome approval process that could have a chilling effect on market innovation and impede the flow of new products and programs to meet new demands. Ultimately, we believe that this provision would hurt housing consumers.

Repeal of GSEs' Lines of Credit with the Treasury

Section 136 of H.R. 3703 proposes to repeal the Treasury's line of credit with the GSEs -- the authority to purchase $2.25 billion of Freddie Mac and Fannie Mae securities and $4 billion cumulatively of obligations of the Federal Home Loan Banks. This authority, which has never been used, is an integral feature of GSE status that provides Fannie Mae, Freddie Mac and the

Federal Home Loan Bank System with their key benefit -- the ability to raise capital at rates that benefit homeowners and renters throughout the nation.

All of us are aware of what happened in the financial markets following the March hearing. These events are a clear demonstration of the importance of the Treasury's securities purchase authority to the financial market's perception of the GSEs and the potential for unintentional damage from possible changes. We urge Congress to carefully consider the consequences that elimination of this key pillar of GSE agency status could have on the housing finance system and the cost of homeownership.

Conclusion

NAHB has appreciated the opportunity to share our views on H.R. 3703, the "Housing Finance Regulatory Improvement Act of 2000." As I said at the outset of my remarks, we believe that the housing finance system works well due largely to the critical supports provided by the housing government-sponsored enterprises, Fannie Mae, Freddie Mac and the Federal Home Loan Bank System. NAHB opposes the withdrawal of the federal privileges and legal exemptions specified in the GSEs' charters or any other actions that would dilute the financial market's perception of the GSE status of these institutions. We appreciate the Subcommittee's efforts to assess and seek improvements to the regulatory framework for the GSEs and we are interested in continuing to participate in this process as we move forward. NAHB would be willing to facilitate dialogue on this issue if the Subcommittee feels that this would be helpful. Ultimately, NAHB believes that any regulatory regime for the GSEs must allow these institutions to fulfill their public missions to support the housing finance system in a safe and sound manner.

Attachment 1

NAHB
National Association
of Home Builders

June 27, 2000

The Honorable Alan Greenspan
Chairman
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

Dear Chairman Greenspan:

On behalf of the 200,000 members of the National Association of Home Builders, I wish to express serious concerns about your comments in a letter dated May 19, 2000 to Representative Richard Baker (R-LA). We understand that your comments were prepared in response to a request by Mr. Baker in his capacity as Chair of the Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises in the House of Representatives, and as author of H.R. 3703.

In your letter, you discussed the benefits derived by Fannie Mae, Freddie Mac and the Federal Home Loan Banks from government sponsorship. One of the benefits on which you focus is the implicit government guarantee which lowers borrowing costs of these government-sponsored enterprises (GSEs) and permits them to provide an interest rate subsidy to home buyers. Your comments appear to be critical of this process since it diverts more of the nation's real resources into housing and homeownership, as opposed to other market-determined uses.

We feel obligated to take exception with your implication that diversion of capital into housing is a misallocation of resources and that these decisions should be based solely on market forces. Throughout our history, during many administrations and many Congresses, our policy makers, representing the will of the people, have determined that fostering homeownership is very positive social and economic policy. Indeed, empirical evidence indicates that when people own their homes they have a greater commitment to their community and are more productive citizens.

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Your letter also argues that the Federal Home Loan Banks, Freddie Mac and Fannie Mae were created to smooth regional imbalances in mortgage supply and to integrate regional mortgage markets into the national capital markets, and that this goal was accomplished many years ago. Actually, the mission of the GSEs is broader than that, and their goals include increasing the nation's homeownership rate and supporting the affordable housing markets. With the help of the GSEs, the national homeownership rate reached an all-time high of 67.1 percent in the first quarter of 2000. This achievement is in no small part the result of the efforts by the GSEs to expand homeownership opportunities for low and moderate-income borrowers. The GSEs also have made great strides in improving rental housing financing. Despite these achievements, however, much work remains to be done. Homeownership rates for minorities and certain other segments of our population remain low. Moreover, the multifamily market still lacks a vibrant secondary market. The GSEs' continuing role in providing capital for a secondary market is critical to filling these gaps in the housing finance system.

Mr. Chairman, we recognize that the record homeownership rate we currently enjoy is significantly due to the perceptive manner in which the Federal Reserve Board of Governors has steered monetary policy. The low inflation, low interest rate and strong economic growth environment of recent years has certainly been a key factor in the recent homeownership boom. However, until all Americans enjoy decent and affordable housing, as well as the opportunity for homeownership, the critical supports provided by the GSEs to the housing finance system should not be weakened.

Thank you for consideration of our views on this vital issue to the housing sector, the economy and the nation.

Sincerely,

Robert L. Mitchell
2000 President

Testimony of

America's Community Bankers

on

Improving Regulation On the Three GSEs
&
H.R. 3703, the Housing Finance Regulatory Improvement Act

before the

Banking and Financial Services Committee
Capital Markets, Securities, and Government Sponsored Enterprises Subcommittee

of the

United States House of Representatives

on

July 20, 2000

David Bochnowski
Chairman and CEO
Peoples Bank, SB
Munster, Indiana

and

Vice Chairman
America's Community Bankers
Washington, DC

Mr. Chairman and Members of the Committee, I am David Bochnowski, Chairman, President and CEO of Peoples Bank in Munster, Indiana. Peoples Bank is a $400 million community bank that typifies the membership of ACB

I am here today representing America's Community Bankers as ACB's first vice-chairman. ACB represents the nation's community banks of all charter types and sizes. ACB members pursue progressive, entrepreneurial and service-oriented strategies in providing financial services to benefit their customers and communities. Our members are both state and federally chartered and portions of our membership are regulated by each of the federal regulators.

Challenging the Financial Community to be Prepared for the Future

We appreciate this opportunity to testify about the activities and appropriate oversight of the housing sector's government sponsored enterprises (GSEs). These issues, which you have raised in your legislative proposal and have discussed over the course of the past four hearings are of great interest to ACB members.

As depository institutions, virtually all of ACB's members are focused on meeting the credit needs of the communities where they operate and view residential mortgage finance as a core business activity. Consequently, the issues of the mission and safety-and-soundness of GSEs are at the forefront of the policy issues with which ACB is concerned. Mr. Chairman, ACB commends you for taking on these challenging and important issues, and thanks you and the other members of the subcommittee for placing these topics on your agenda. These issues are important to the financial community and we must work together to consider the appropriate scope and regulation of the GSEs.

ACB's Policy Position

The GSEs have been, and continue to be, an important part of the housing finance system. ACB supports the role Fannie Mae, Freddie Mac, and the Federal Home Loan Banks (FHLBanks) have played in funding residential mortgages. ACB also supports a public policy review of Fannie Mae's and Freddie Mac's current and future activities. ACB recommends to Congress that:

- Any legislative proposal should effectively authorize and require the regulators of the GSEs to engage in appropriate mission and safety and soundness supervision;
- GSE program review should ensure that new or expanded activities are based on mission fulfillment and do not subsume or discourage competition between current private-sector participants; and
- Regulation of the FHLBank System should not be consolidated with that of Fannie Mae and Freddie Mac. The FHLBank System is a cooperative system, while Fannie Mae and Freddie Mac are publicly traded companies requiring separate and different regulation.

In 1998, ACB formed a GSE Task Force to consider the more general policy issues with which this subcommittee is now grappling. Also, for many years, ACB has maintained a member committee that serves as our liaison with Fannie Mae and Freddie Mac on technical secondary market issues, as well as a standing committee on the operations of the Federal Home Loan Bank System.

America's housing and housing finance system is a mixture of private sector and government-supported organizations and initiatives, including many state and local entities. The GSEs have played a significant role in the evolution of our housing finance system that has allowed more and more families to own their own homes. ACB believes that the successes of our nation's unique and highly developed system of housing finance have been the result of the balance between the private sector primary market participants, secondary market participants, and other government-sponsored enterprises. The unique synergy between primary mortgage lenders and the GSEs has succeeded in extending the benefits of home ownership to a record percentage and number of Americans.

These roles between private sector community lenders and GSEs should not change. Private sector lenders should be the point of contact with borrowers, bringing credit opportunities to the public with the support of GSEs. It is the possible change in this balance and synergy, to the detriment of housing finance and the marketplace, that concerns us.

The Federal Home Loan Bank System may have the lowest public profile of the GSEs, but it plays a very vital role in enabling community-based depository institutions to extend needed and affordable residential and

community-based credit. The FHLBank System is a cooperative that builds on and strengthens the role of community-based lenders in supporting local economic development. The FHLBanks' primary mission of providing advances and making funding available to their member-owners for residential and community-based lending, will continue to grow in importance as the new community financial institution provisions contained in the Gramm-Leach-Bliley Act are implemented.

ACB believes that the constructive role of Fannie Mae and Freddie Mac must also be recognized for the value and contribution of their secondary markets purchase programs, including their affordable housing activities. They have been very successful in fulfilling their statutory mission of providing stability to the secondary market for residential mortgages and promoting access to mortgage credit by increasing the liquidity of mortgage investments.

Important as the three GSEs' roles have been and should continue to be, it should be well recognized that they do not themselves get a single borrower into a home. They are, and should remain, secondary market entities that service primary market lenders. It is the primary market lenders, like ACB's members, that deal directly with the homebuyer and borrower.

Secondary Market Access versus Community Lender Role

Fannie Mae and Freddie Mac provide elements of both cooperation and competition with the typical ACB member. From the perspective of the smaller volume originator, the willingness of these two GSEs to act as a conduit to secondary market investors has helped maintain diversity and viability within the lending community. From the point of view of that smaller originator as a portfolio lender, however, the size and outreach of these same two GSEs have put severe pressure on earnings margins and has often acted to pressure a conversion of primary market players into little more than 'branch offices' for secondary-market-destined lending. The term "co-opetition", sometimes used to describe the system of shifting alliances in the high-tech "new economy", may aptly express the mixed emotions that the GSEs elicit from many lenders that have both portfolio and secondary market lending operations.

The Congress and the regulator for Fannie Mae and Freddie Mac must exercise vigilant oversight to ensure that the subtle balance between these GSEs and private market lenders is not upset. Only with a proper regard for maintaining that dynamic equilibrium can the best of the mixture of semi-public and private ventures be sustained. By its very nature, this requires an ongoing process, not occasional attention.

Mission Creep

The evolution of Fannie Mae and Freddie Mac is ACB's primary concern. As current lines of business have matured, these two GSEs have searched for new product lines to satisfy the expectations of their shareholders. ACB is specifically concerned about mission creep that is driven by stockholder expectations. These stockholder expectations, and management incentives designed to fulfill these expectations, can result in GSE business strategies that discourage or subsume the roles of other mortgage market participants. Legislation is necessary to limit such mission creep, and the regulators must assume a more active role in mission oversight.

For example, a GSE might state that their mandate includes being ready to buy any loan that a seller/servicer presents, provided that it is collateralized with residential real estate. Such loans, however, generally finance consumer purchases and are not consistent with the basic mission of promoting homeownership. Borrowers seeking this type of junior financing already have achieved homeownership. ACB does not see any corresponding justification for GSE entry into the home equity line of credit business, even if the GSEs and their stockholders might find that business attractive from a profit perspective. Therefore, we oppose any expansion of Fannie Mae and Freddie Mac into the home equity line of credit market.

Activities of the housing GSEs that diminish the roles of other participants in the mortgage market should receive careful review to ensure that the proper balance of public and private roles is maintained. ACB would like to emphasize that the cooperative structure of the FHLBank System serves as a built-in safeguard against undue expansion of that particular GSE's activity. The "drivers" of that housing-sector GSE do not include the profit and scope maximization goals of Fannie Mae and Freddie Mac.

Exclusivity of GSE Relationships

ACB recognizes the importance of market innovations. ACB members lend for their own portfolios to a larger extent than any other insured depositories and have been responsible for many innovations in the development of mortgage loan products and delivery systems. The GSEs have been innovative as well. However, their drive to innovate must be put in proper perspective with their role of maintaining balance in the mortgage markets. Legislative and regulatory review should seek to ensure that the desire to innovate does not result in creating exclusive or closed relationship based activities or programs. For example, consider the joint venture between Freddie Mac and HomeAdvisor Technologies, Inc. (HTI).

HTI is a Microsoft spin-off, capitalized by Microsoft and a small number of large-volume mortgage lenders. As we understand, Freddie Mac is taking a subordinated debt position with some equity warrant upside potential. What Freddie Mac brings to the venture is access to its sophisticated automated underwriting computer software (Loan Prospector) and an impressive array of related computer-based services, such as on-line statistical appraisals and loan rate locks and approvals.

ACB has had a number of discussions with Freddie Mac about this program, and raised concerns in a letter to Leland Brendsel, its Chairman and CEO, on May 5 of this year. Subsequently, on June 9, ACB requested that the Department of Housing and Urban Development (HUD) and Office of Federal Housing Enterprise Oversight (OFHEO) exercise their proper review of the initiative. In ACB's letter to Freddie Mac we discussed our concerns regarding the relationship of Freddie Mac to the consumers and the question of accessibility of the program to non-equity players. In their response, Freddie Mac said that loans "will be originated by" their "lending partners" and that "HTI will make its lender tools available to lenders of all sizes." Several of ACB's members asked to participate in HTI and were denied.

ACB's primary concern is that the venture does not appear to have an "open architecture" structure allowing any lender willing to pay a commercially reasonable price for the system to use it. This raises the policy issue of a GSE engaged in a venture that gives preferential treatment to one group of their lenders over all their others. We would also raise the

separate issue of whether this or related ventures would bring the GSEs inappropriately close to the prohibited role of mortgage origination.

GSE Effect on Financial Markets

Some of the more severe critics of the role and operations of the GSEs argue that they distort the outcomes otherwise emanating from purely private decision making, and thus should be privatized. That GSEs alter economic outcomes is clearly true, but the GSEs can correct as well as create market imperfections. For example, Fannie Mae and Freddie Mac help address the imperfection of impaired access of smaller, lower volume lenders to the capital markets, although the FHLBanks may be an even better example of this crucial conduit function. While some critics of GSEs may be too aggressive in alleging damage from GSE activities, the GSEs have been too sanguine in arguing that their operations have no adverse impacts whatsoever. Both the pluses and minuses of GSE activities have to be fairly identified and estimated, and the best net value sought.

GSE Liabilities and Financial Market Risk

A final area that has generated considerable discussion has been the risk that may be associated with the level of GSE debt in the market. ACB does not believe that there is any current level of inappropriate risk associated with the GSEs' activities, nor with the level of GSE, or other mortgage-related, debt currently in the marketplace. Congress and regulators are and should be concerned with the systemic risk associated with large international financial conglomerates and the effect such a single company failure might have on broader financial markets. Congress and regulators also should be concerned with systemic risk as applied to the GSEs. The GSEs and the appropriate regulators must be prepared to deal with potential problems if they arise.

The trend of overall financial sector policy has been to countenance the creation of larger entities of both the fully private and the mixed status of the housing sector GSEs. The same legislation that produced the important amendments to the FHLBank Act had as its major focus the elimination of the traditional barriers between the various types of financial service providers in the banking, brokerage, and insurance sectors. There is little doubt that the net result will be the creation of more giant, integrated financial services conglomerates like DeutscheBank, that has operated for

some time in Europe. If these integrated entities truly achieve the economies of scale and scope that their shareholders are promised, it seems likely that the issue of "too big to fail" will be revisited in the private as well as the GSE domain.

The capital rules for all of the housing sector GSEs are especially important because these rules are the basic safeguard against ever having to determine how far any federal backstop on the liabilities of GSEs may extend. The financial sector's difficulties in the mid- to late-1980s through the early 1990s extended to the federal deposit insurance funds and to the Farm Credit System. Fannie Mae had earlier shared the problems of the entire mortgage lending business in the high rate period of the early 1980s but was extremely successful in restructuring its operations and its market risk exposure and, together with the entire banking system over the last decade, has rebuilt its capital cushion to record levels.

Limiting systemic risk in all sectors of the financial system must be an important priority. ACB believes that legislative and regulatory diligence in maintaining an appropriate capital adequacy regime and mission focus are essential to limit potential costs to the taxpayer.

Fannie Mae's and Freddie Mac's Mission

The specific statutory purposes for which Freddie Mac and Fannie Mae were originally chartered, and which continue to make up their mission today are:

- to provide stability in the secondary market for residential mortgages;
- to respond appropriately to the private capital market;
- to provide ongoing assistance to the secondary market for residential mortgages (including activities relating to mortgages on housing for low- and moderate-income families involving a reasonable economic return that may be less than the return earned on other activities) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing; and
- in turn to promote access to mortgage credit throughout the nation (including central cities, rural areas and underserved areas) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing.

ACB is persuaded by both recent and more distant experience that the GSEs have demonstrated considerable success in meeting these charter goals. The activities of the GSEs in the troubled and fragile financial markets of the summer and fall of 1998 clearly contributed to the continuation of the strong lending performance of the last seven years.

ACB recognizes the continued importance the GSEs provide to the overall promotion of housing finance and urges you to keep that consideration at the forefront of the Committee's efforts. ACB also urges you to ensure that GSEs maintain their focus on the segments of the housing market where borrowers do need and deserve some federal assistance to realize the dream of homeownership.

H.R. 3703 Legislative Proposals

Mr. Chairman, ACB supports your introduction of H.R. 3703, the "Housing Finance Regulatory Improvement Act," and pledges to work with you to ensure that the GSEs continue to be effective partners in expanding homeownership in America. Providing appropriate and effective regulatory oversight of the GSEs will benefit the GSEs, private mortgage market participants, and consumers.

Creation of New Agency

H.R. 3703 would create the Housing Finance Oversight Board (The Board) as an independent agency with the Treasury and Housing Secretaries serving as two of the board members. The new Board would consolidate the responsibilities of OFHEO, the Federal Housing Finance Board (FHFB), and HUD into one agency. HUD's role in relation to the Fannie and Freddie, including affordable housing goals, would be moved to the new Board.

ACB supports the consolidation of both mission and safety-and-soundness oversight in a single regulator. That is the current regulatory format for the FHFB. ACB is opposed to consolidating the federal oversight of the FHLBank System with regulation of Fannie Mae and Freddie Mac because of the different nature of the capital base, ownership structure and the motivation for new programs. It would be difficult to maintain appropriate differential regulation of the FHLBanks and the other two GSEs

in a single agency, considering the vastly different natures and necessarily different risk-based capital requirements.

New Board's Authority

Under H.R. 3703, the Board's responsibilities would include regulatory oversight to assure that the GSEs operate in a financially safe and sound manner, carry out their mission consistent with their respective statutory authority, and remain adequately capitalized.

ACB is strongly supportive of providing the regulator of the GSEs with strong supervisory authority. It is even more important that the regulator accepts and assumes that responsibility on a day-to-day basis. H.R. 3703's approach of creating a regulator with the singular responsibility to regulate Fannie Mae and Freddie Mac is a key step toward this end.

Approval of New Activities

H.R. 3703 would direct the Board to approve all new activities of the GSEs before a new activity may be commenced. Such approval would require that: (1) the activity be authorized under the statutes governing the particular GSE; (2) the Board determine the activity can be conducted in a safe and sound manner; and (3) the Board determines the activity is in the public interest.

ACB believes this is an extremely important aspect of the legislation and supports requiring new program or activity review and approval. The manner in which a new program approval process is crafted, however, is complicated. The GSEs have a legitimate concern about their need to maintain confidentiality of proprietary information, some of which belongs to counterparty sellers/servicers bringing new product ideas to the GSEs for introduction to the marketplace. Such confidentiality should be preserved. Also, in today's fast-moving markets, delays in approval can render a useful idea obsolete before it ever gets a chance to be introduced.

The concept of modest initial holdings, or of 'pilot program' status, may also be a way to address the difficult issue of program review and approval by the federal regulator. It might be useful to adopt the "pilot program" approach that the FHFB has used for certain new ventures,

whereby some experimentation can be conducted before an idea can become an open-ended offering of a GSE.

While construction of an appropriate new program and activity approval process may be difficult, it is an important goal to pursue. Such a process might have helped prevent the concerns that now exist with regard to the joint venture between Freddie Mac and HTI, discussed earlier in this testimony. To Freddie Mac's credit, an informal briefing process for interested parties was conducted. Had there been greater review of the venture in a public forum, a more "open architecture" may have been possible at inception. A proper new program approval process would help ensure that a GSE does not engage in a venture that preferentially assists one group of lenders over all others.

In addition, ACB would recommend that the new program approval process should include, as a condition for any activity approval, that the GSEs maintain the appropriate arms-length distance from the origination process.

Limitation on Nonmission-Related Assets

Under H.R. 3703, the new Board would be required to define mission-related assets, and, by regulation, limit nonmission-related assets. The bill does not suggest how or to what extent the Board must limit nonmission-related assets.

ACB believes that a clearer definition of Fannie Mae and Freddie Mac's mission would be helpful. Unlike the FHLBank System, whose cooperative structure effectively creates a checks and balances approach on the activities of the FHLBanks, Fannie Mae and Freddie Mac have an incentive to seek out new activities or markets to maximize shareholder returns.

As stated above, ACB does not believe that expansion of Fannie Mae and Freddie Mac into the home equity line of credit market is consistent with their basic mission to promote homeownership. These borrowers have already attained homeownership. ACB recognizes the distinction between the borrower seeking a home improvement loan for a significant upgrade in the property.

ACB has some concerns with the legislation's treatment of nonmission-related investments. The federal regulator is also charged with imposing limits on such positions. ACB has engaged in a prolonged dialogue with the FHFB on this issue regarding FHLBank investments. ACB has also observed parallel discussions being conducted between Fannie Mae and Freddie Mac and HUD.

It clearly makes sense to establish limits on nonmission related investments to ensure that: (1) private sector market participants are not subjected to unfair competition and (2) safety and soundness standards are not violated. However, holdings of nonmission-related assets for the purpose of maintaining adequate liquidity is a prudent practice, and arbitrary limits should not impair this activity. Some level of Fannie Mae's and Freddie Mac's liquid investments as a percentage of their total assets seems consistent with their basic business operations and their mandate to supply liquidity to the mortgage market. Whether these entities need to hold so much MBS product to add liquidity or whether it is a profit-motivated may be less clear-cut.

Conforming Loan Limits/Housing Price Index

H.R. 3703 would amend the Federal National Mortgage Association Charter Act for Fannie Mae and Freddie Mac establishing a statutory limitation on adjusting the conforming loan limits.

ACB agrees with this maintenance of appropriate limits on the size of the mortgage loan that the GSEs can purchase and securitize. This section of the bill codifies the current practice of the GSEs in applying declines in the underlying index of loan size and is symbolic of the ongoing commitment of the Congress to focusing the activities of the GSEs to the correct segment of the borrower universe. Similarly, the system of geographic and income-level targeting for the GSE book of business that was crafted in the landmark 1992 legislation has been valuable in concentrating their attention in the right places.

Risk-based Capital Tests

H.R. 3703 would authorize the Board to adjust the risk-based capital requirements for any or all of its regulated entities based on interest rates, home prices, and new business.

ACB supports risk-based capital standards for the GSEs. It is absolutely critical that the differences between the cooperative structure of the FHLBank System and the publicly traded corporate structures of Fannie Mae and Freddie Mac are incorporated into separate risk-based capital standards. While both should be subject to risk-based standards, creating a uniform approach would not properly serve their different missions or business approaches.

In addition, it has taken considerable time for risk-based capital rules to be developed for Fannie Mae and Freddie Mac. Now that those rules are close to being implemented, they should not be further delayed. The required new capital structure for the FHLBanks is discussed later in this testimony.

Repeal of Treasury Line of Credit

The bill would repeal Fannie Mae's and Freddie Mac's $2.25 billion Treasury lines of credit and the FHLBanks' $4 billion Treasury line of credit.

ACB does not support repeal of the Treasury lines of credit. Although they account for little more than a single day's business for the GSEs, the Treasury lines of credit are significant to all of the GSEs. To date, not one of the GSEs have had to ask Treasury to use the lines of credit.

While none of the GSEs are backed by any Federal government guarantee, implied or otherwise, the Treasury line of credit is symbolic and carries significance in the financial markets. Eliminating the Treasury line of credit could be expected to increase residential mortgage credit costs. Careful review of the costs balanced against any benefits of a repeal should be considered before such action is approved.

FHLBanks' Super-lien Eliminated

The statutory priority given a FHLBank's security interest in the assets of a member financial institution that fails would be eliminated by H.R. 3703

ACB opposes the repeal of the FHLBanks super-lien authority. While a FHLBank could act to secure the collateral, effecting the similar credit priority as provided by the current statutory authority, to do so would involve new costs for the FHLBanks. There is little, if any, benefit accompanying these costs, which would in turn increase the cost of advances and the cost of residential and community-based credit.

Capital Treatment of Private Label MBS

H.R. 3703 would express the sense of the Congress that the proposed rules issued jointly by the Federal banking agencies, addressing the treatment of privately issued mortgage backed securities under risk-based capital requirements, should be adopted as final with no substantive changes. The proposed rules afford private label MBS, if AAA rated, the same treatment as similar securities issued by the GSEs.

ACB supports this provision, which would improve competition in the MBS market benefiting financial institutions. Such a change might also assist in reducing the GSE debt concentrations at the financial institution level by giving private label MBS debt similar capital treatment as GSE issue debt.

Federal Home Loan Bank System

I would like to take a moment to discuss some important FHLBank System issues. The FHLBank System is going through substantial changes now, mostly as a result of the Gramm-Leach-Bliley Act amendments to the Federal Home Loan Bank Act. Properly implemented, those changes, for which you were primarily responsible, Mr. Chairman, should allow the FHLBank System to continue to serve its owner-members and the communities they serve well into the future.

FHLBank Capital Structure

The Gramm-Leach-Bliley Act requires the FHFB to issue regulations prescribing uniform capital standards by November 12 of this year. Development of the new capital structure has proven to be a very complicated process, which requires creation of separate risk-based and leverage-based capital requirements, and involves the conversion of the current stock holdings of every member of the FHLBank System to new

forms of stock. Many questions remain regarding the manner in which various approaches to new forms of stock will be treated. The FHLBanks and their members do not know yet what the tax, accounting, or capital treatment for various forms of stock purchase or conversion will be.

To ensure that the FHLBanks and the current and prospective stockholders of the System have all the necessary information available to develop and submit informed comments on the proposed rule, sufficient time is necessary. On July 17, ACB and approximately twenty state trade associations sent a letter to you and a number of your colleagues requesting an extension for the FHFB to complete its rulemaking process and comment period. We hope that the Banking Committee will encourage the FHFB to extend the rulemaking process until the outstanding questions can be answered and the proper decisions made.

The development of a sensible capital rule is vital to the development of sound capital plans by the FHLBanks. ACB agrees with the views, including those of the Department of the Treasury, that maintaining the distinguishing feature of this cooperative format should be a prime element of the ongoing evolution of the FHLBank System. ACB appreciates the caution that the Congress showed in last year's amendments to the capital regime for the FHLBanks. Congress carefully provided for more stability to the capital base of the System without moving to a format that would facilitate the further change of allowing public shareholders.

ACB believes it is extremely important to consider the full ramifications of implementing the statutory changes to the capital base of the System that were included the Gramm-Leach-Bliley Act. In addition, the issue of voting rights for the Class A and Class B stock holders and how that will affect the representation of the full range of asset size and geography among the member depository institutions itself involves difficult matters of statutory interpretation and optimal corporate governance. ACB recommends that this subcommittee consider appropriate oversight hearings early next year prior to the FHFB's issuance of final capital regulations.

Core Mission Activities (CMA) and Acquired Member Assets (AMA)

On June 29, the FHFB adopted a regulation that defines CMA and authorizes a new category of asset, AMA. ACB opposes the FHFB's creation of a category of assets that defines the core mission of the FHLBank

System. We believe that the mission of the System is made clear in statute and that the FHLBanks and their members are in the best position to determine how to achieve that mission successfully.

Right now, the CMA serves only as guidance and does not harm the operations of the FHLBanks. If targets or limits are imposed in future regulation, the ability and flexibility of the FHLBanks to address the needs of their members and the communities they serve will be impaired. The Gramm-Leach-Bliley Act shifted governance to the FHLBanks for a good reason; they know better than Washington what their communities need. Congress was also correct in strengthening the safety and soundness regulatory role of the FHFB to assure that the FHLBank System operates at minimum risk.

ACB supports the new category of asset called AMA. This action by the FHFB lifted the pilot status of and cap on the mortgage partnership-type programs (programs like the FHLBank of Chicago's MPF). The mortgage partnership programs are designed to increase capital available for mortgage lending and provide commercial banks and thrifts competitive alternatives in the secondary mortgage market. These programs should be allowed to earn their way onto the balance sheets of FHLBanks.

Recently, we have learned that the Senate Appropriations Subcommittee on Veterans Affairs, HUD and Independent Agencies is considering an amendment to the FY2001 appropriations bill that would, in effect, put a retroactive cap on these programs. Just as it would be wrong for the FHFB to mandate specific minimum levels for the mortgage partnership programs or other CMAs at each FHLBank, it would be equally wrong to impose legislative limits on the mortgage partnership programs. To do either could artificially expand or restrict the programs, thereby stifling marketplace competition that ultimately benefits consumers. The appropriate regulatory safety and soundness standards are in place. The program should be allowed to grow based on the risk-reward benefits it provides to the member-owners of the cooperative FHLBank System.

Conclusion

ACB is aware that attempting to view all sides of these issues is an intricate and perhaps perilous task. ACB welcomes the willingness of this Subcommittee to engage in these issues. ACB also seeks to ensure that the

higher-profile issues that are raised by any changes to the rules under which Fannie Mae and Freddie Mac operate do not submerge the very different structure and concerns of the FHLBank System. The two different structures must be kept separate.

ACB believes that H.R. 3703 is an important and timely legislative initiative, and raises public policy issues that must be addressed. The size and scope of the GSEs raise fundamental questions, both for the structure of housing finance in America and for the safety of the marketplace. The consumer deserves competitive opportunities in a secure marketplace, and the taxpayer demands that risks to the government be managed and minimized.

Mr. Chairman, thank you again for the opportunity to testify before the Subcommittee. I would be happy to respond to any questions the members of the Subcommittee may have.

July 13, 2000

John O. Norquist
Mayor

The Honorable
Richard Baker
U.S. House of Representatives
Washington, D.C. 20515

Dear Congressman Baker:

I read your July 24, 2000 *Forbes* article. Thank you for taking a skeptical view of Fannie Mae's and Freddie Mac's federally bestowed privileges. I believe they have distorted lending markets to the disadvantage of cities and the low and moderate income residents of cities.

I'm enclosing a chapter from my book *Wealth of Cities* that advocates reduction of federal interference in the mortgage market.

Sincerely,

JOHN O. NORQUIST
Mayor

Enclosure

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CHAPTER SIX

How the Government Killed Affordable Housing

WHEN I CONSIDER what has happened to U.S. cities over the last fifty years, when I consider the destructive impact of federal programs—grossly excessive road building, the elimination of most trains and transit, FHA-subsidized suburbanization, and other inducements to sprawl, when I consider the resulting social chaos and confusion, as the son of a Presbyterian minister I turn to the first chapter of the Lamentations of the prophet Jeremiah:

How lonely sits the City that was full of people.
How like a widow she has become.
She that was great among nations.
Princess among provinces has become tributary.
She weeps bitterly in the night.
Tears on her cheeks.
Among all her lovers she has none to comfort her.
All her friends have betrayed her.

In 1965 the federal government did what it often does when it creates suffering. It grew a new bureaucracy named after the problem it created. In this case it created the Department of Urban Development—*urban* as in urban problem, urban dilemma, urban distress, urban decline, urban decay, and, ultimately, urban death.

Forbes Magazine
July 24, 2000, p. 36
"On My Mind" Column

An implicit subsidy of burgeoning Fannie Mae and Freddie Mac must be held up to greater scrutiny, for everyone's sake.

Popular Delusions

Tim W. Ferguson, Editor

By RICHARD BAKER
LOUISIANA CONGRESSMAN,
CHAIRMAN OF THE HOUSE BANKING SUBCOMMITTEE ON CAPITAL MARKETS

In 1711 the South Sea Co. received from the English Crown a chartered monopoly on trade with the "New World"--in short, a very lucrative implicit subsidy.

At about the same time, Parliament had embarked on a plan to reduce the amount of publicly held debt, and the South Sea Co. answered the call. It became both the largest holder of and issuer of benchmark debt in England. The company's stock, unsurprisingly, rose within months from 128 to more than 1,000 pounds, investors perceiving that government ties made the company too big to fail. Soon, however, a downturn in trade from the Americas caused market nervousness.

For a time the South Sea Co. put off the inevitable by repurchasing its own debt offerings. When the company ultimately tanked, the Bank of England stepped in with millions to assist in a government bailout, and the executives of the South Sea Co. and the members of Parliament who sponsored their schemes were thrown into the Tower of London.

"They have contributed to reducing mortgage rates but, as Chairman Greenspan points out, 'only to the degree that they pass through to home buyers part of their government subsidy.' "

This is a funny and eerily familiar story about how some government subsidies, initiated with the best intentions, can lead, if not properly supervised, to disaster.

Today Fannie Mae and Freddie Mac, sibling housing-finance corporations, are

the U.S. versions of court favorites. They trade as privately held companies but they have, by dint of their history as government-sponsored enterprises, a market-perceived government guarantee of their debts. The nonpartisan Congressional Budget Office in 1996 estimated that that implied subsidy was worth $6.5 billion a year, $2.5 billion of which went into the pockets of shareholders. (The National Taxpayers Union puts those numbers at $10 billion and $3.5 billion in 1999.) The two companies' annual return on equity, averaging 24% in the late 1990s, well exceeds those of other financial institutions. Not surprisingly, Fannie and Freddie's assets quintupled to $962 billion in the home mortgage boom of the last decade.

This state of affairs is attracting criticism from all quarters. Ralph Nader calls the housing finance twins "poster children for corporate welfare." The American Enterprise Institute faults the federal subsidy for "squeezing out private sources for mortgage finance." HUD is reporting that, despite the subsidy, the private sector outpaces Fannie and Freddie in low-income and minority lending. The Treasury has endorsed a repeal of the credit guarantees that underlie the subsidy. And Alan Greenspan has all but stated that the two companies' advantage in the capital markets may no longer be necessary.

Now, as a free-market Republican, I've got nothing against unlimited profits fairly gained. What's troubling, however, is the lopsided nature of the arrangement, suggesting that any profits they make they keep, while any losses are the taxpayers' to pay. True, the two entities have contributed to reducing mortgage rates, but, as Chairman Greenspan points out, "only to the degree that they pass through to home buyers part of their government subsidy."

No wonder Fannie and Freddie work hard to wash away the facts about the subsidy. But I've asked the CBO to recalculate the numbers, and the Fed will monitor the results. Expect them at the first of next year. Meantime, I have introduced a bill to establish a single independent oversight board to monitor both the soundness of government-sponsored enterprises and their mission compliance. The talented lobbyists employed by these two entities have been turned full force against my bill, but knowledgeable opinion, such as that in the financial press, is not buying their line.

The economy is strong now, and Fannie and Freddie are financially safe. But my greatest goal is to see that taxpayers are never asked to pick up the tab on trillions of dollars of their debt. Stronger oversight will benefit the companies themselves and their investors, who, while continuing to prosper, should also thrive with the steady certainty that their safe investment will never go the way of the South Sea Co.